A flexible approach

Tristan Hanson considers whether pension schemes can avoid drawdown without sacrificing return

Fundamental to investment theory is the tenet that to generate return, we need to take risk. By the same rule, prioritising greater certainty should involve sacrificing return. This represents a challenge for pension schemes looking for growth to support their funding levels, while at the same time seeking to minimise the negative impact of market volatility.

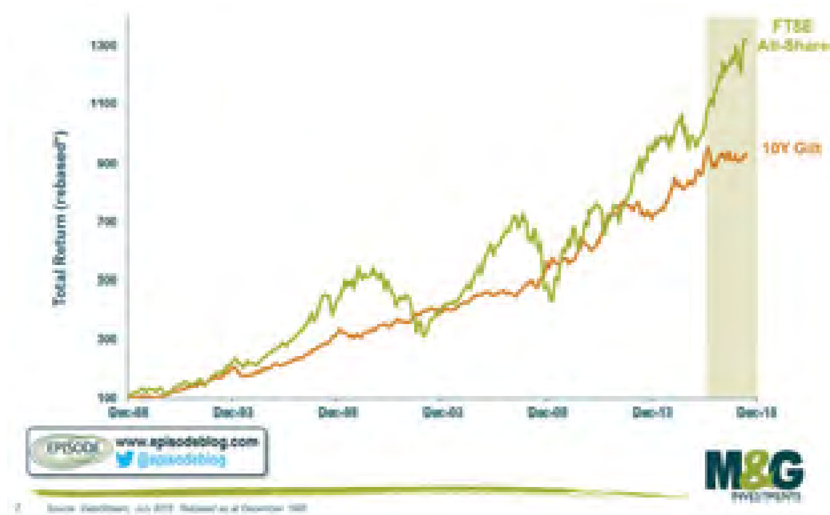
It is possible to deliver these dual objectives today, targeting attractive returns while limiting the extent of short-term drawdown – but it requires significant flexibility of approach. This is true even of investment styles that have been able to deliver such outcomes since the financial crisis, which will need to adapt to the new environment in which we find ourselves.

The risk-return trade-off

Investment risk is at simplest the degree of uncertainty around reaching a required objective over an investor's time horizon. Here, risk is specific to each investor and is about the destination, not the journey. It is something that is also hard to objectively quantify, despite the best efforts of the financial industry.

Traditionally pension schemes and other institutional investors have been beneficiaries of their longer time horizons. By tolerating shorter-term uncertainty of returns (volatility) they have been able to earn the extra compensation that is often on offer for doing so. In fact, it has arguably been the case that extending one's time horizon actually increases the certainty over the nature of the return to be delivered, since it smooths the impacts of short-term noise and cyclical behaviour.

Figure 1. Safety hasn't been costly until recently: FTSE All Share and 10-year gilt total returns



Pension schemes' need to manage volatility and drawdown

Today, managing volatility – specifically, the downside risk associated with it – is a priority for pension schemes. This is partly a consequence of schemes maturing and receiving fewer contributions, as well as higher cashflow needs, which is leading to a greater focus on certainty of returns and preservation of capital.

The growing interest of pension funds in hedging equity downside risk is highlighted in the *European Asset Allocation Survey 2018* from Mercer, which cites 9 per cent of respondents as having implemented equity-option protection strategies, while a further 24 per cent had considered doing so.

This represents a significant challenge. Without the benefits that longer time horizons can provide, many institutions are likely to become more reliant upon active management of assets to lower volatility-related drawdown in their portfolios. Assessing the shifting nature of the trade-off between volatility and return will be a central element of this.

How costly might it be to focus on the short term?

The amount of return that must be given up in exchange for greater certainty is not constant: the starting point of asset valuation and the broader economic environment matter. It may even be the case that no such trade-off needs to be made.

Prior to the financial crisis for example, 10-year gilts had a yield after inflation that was similar to the dividend yield on the FTSE All-Share. Though one was still sacrificing the prospect of growth associated with equity assets, there was an attractive return for those unwilling to tolerate downside risk. Combine this with an ongoing trend toward lower real rates and more benign inflation in the western world since the 1980s, and it can be seen – with hindsight – why there have been significant periods over the past 30 years in which holding safety assets hasn't meant giving up returns.

However, most would accept that this is highly likely not to be repeated. The starting point of yields on traditional safety assets is now extremely low, and the decline in interest rates that has taken them there looks to have reached its limits.

Figure one above shows the flat return from UK 10-year gilts delivered since the middle of 2016, while figure two below illustrates the extent of the trade-off in seeking safety via government bonds that still exists today.

From here it seems that the traditional trade-off between short-term volatility and return is reasserting itself in the major asset classes. Not only that, but 'safe assets' now appear vulnerable to the prospect of delivering material short-term drawdown due to volatility, and with lower likelihood of upside apparently on offer.

Even more importantly, should we have reached a point where interest rates across the world begin to move sustainably higher, then this could have an impact on the valuation of all assets. The recent path of rates in the US has provided a taster of what this could mean, both for prospective returns and the correlation between different assets.

Just as was the case with tapering in 2013, the start of 2018 saw a re-emergence of volatility associated with upward pressure on rate expectations. In these environments, rate-related assets have not provided the safety and potential drawdown protection that most investors have been used to for much of the last 20 years, but have instead been the source of weakness across most major asset classes. This marks a profound shift in the investment environment, one in which investors will need to embrace different tools to deliver the outcomes that pension funds need.

Figure 2. The changing trade-off between safety and growth

Negotiating the new environment

In this environment, strategies that seek to provide attractive returns while managing short-term volatility will need a broader range of tools and greater flexibility to achieve those goals.

It may be the case that significant short-term diversification is simply unavailable in traditional asset classes in periods when the impact of interest rates or inflation provide a correlating downside influence on most assets. In such environments, multi-asset strategies may have to make use of short exposures or relative value positions to protect capital and generate return.

Alternatively, there may be phases where the compensation on offer for tolerating some short-term volatility may be very attractive. Institutional investors will need to be clear exactly how much of such returns on offer they are willing to give up in return for greater short-term certainty. In cases where external managers of assets are used, this will involve a close partnership and high levels of understanding.

Lastly, it may be possible that diversification can be achieved via non-traditional assets or a truly global investment universe. However, this will involve significant understanding of the underlying return drivers; investors cannot simply rely on 'set and forget' allocations to offer diversification in all environments.

Conclusions

It remains possible for pension scheme to target investment goals of both short-term volatility management as well as the level of return they require. However, there are real signs that doing so will involve different approaches to those that have been successful in the recent past.

Among traditional asset classes and investment strategies, the volatility and return trade-off that many of us would expect looks to be reasserting itself: the costs of avoiding volatility through traditional safe havens seem high, and correlation patterns could change.

Pension schemes may therefore need to be prepared to employ more flexible approaches, including more dynamic shifts in allocation, the use of shorting or relative value positions, and a continuation of the willingness to seek out new areas of the investment universe. A wide range of strategies and products have been developed to deliver these characteristics for institutional investors over recent years and they will need to prove their worth in the period ahead.

For more information please visit www.mandg.co.uk/multiasset

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