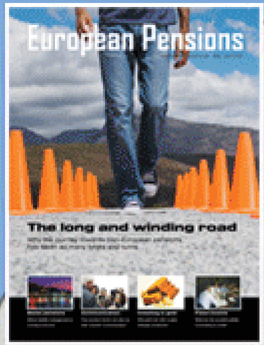
European Pensions



FEATURES

Pension fund investment - an alternative approach

Guy Fraser-Sampson asks why there are such different approaches to alternative asset allocation across European institutional investors

Recent figures from Russell and Watson Wyatt show that large amounts of money are now being deployed by the world's biggest pension funds in so-called alternative assets, the three best-known examples of which are private equity, hedge funds and real estate. However, these figures mask a large difference in approach between the US (where nearly 60 per cent by capital of the world's biggest pension funds are concentrated) and Europe. As we will see, there are also significant differences within Europe between the UK and the rest.

Watson Wyatt unfortunately does not provide a breakdown of its figures, stating merely that these leading pension funds have about $600 bn in alternatives. It is not stated whether this is 'invested' or 'allocated' (there can be up to a 90 per cent difference in the case of private equity), nor how this breaks down between the US and the rest of the world; the figures given in that regard are for total capital under management. However, we can piece together some of what Watson Wyatt does not state.

We know, for example, from the WM annual survey that UK pensions as a whole only have about one per cent of total assets invested in private equity and hedge funds combined.

We know that on a straight pro rata basis US funds would account for about 60 per cent of the $600 billion, but anything like a pro rata approach is invalid since we also know that US pension funds can have dramatically bigger allocations to alternatives than their European counterparts, many of whom still have almost nothing. It seems reasonable to suggest, therefore, that anything up to about $500 bn relates to the US, leaving about $100 bn for Europe as a whole. This sounds like a large number, but to put it into context let us remember that just one part of the alternatives sector, the European buyout industry, raised more than this in a single year during 2006.

Visit any pension conference in Europe and one is struck instantly by a strange sense of unreality. People talk not of investing for high returns, but of matching their liabilities. They speak not of how much money they need to make to cover their long term cashflows, but of reducing the amount of short term volatility in their portfolios.

"I know volatility is irrelevant to pension funds," said one well-known CIO at a conference recently, "but you try telling that to my trustees". Many believe that it is here that the reason for the bafflingly low allocations to alternatives prevalent among European pension funds can be found.

"UK pension funds are largely mature, and believe that they can and should seek to match their liabilities by investing in things like bonds, interest rate swaps, and inflation swaps," says Professor David Blake of Cass Business School. "Alternative assets, with their unpredictable cash flows and illiquid status, do not appear to be suitable for this purpose. That is why when, in the very few cases where any allocation is made to alternatives, it is a very small one."

Some believe that a related problem, and one which incidentally splits the European pension scene down the middle – with the UK remaining stubbornly in a class of its own – is the almost total absence of investment professionals from UK pension funds, whereas funds in the Netherlands, for example, work very differently.

"You have to remember," says Philip Jones of the London Pension Funds Authority, "that in the UK, unlike some other countries, very few pension funds have in-house investment professionals at all, let alone the specific specialists that you require for private equity and other alternative asset investments."

"The difference in approach can be traced directly to staffing," agrees Rebecca Meijlink of Alphabet Capital. "Most Dutch pension funds have in-house investment professionals; most UK funds do not. This means they react very differently to such offerings as hedge funds and private equity.

It also means that the role of the pension consultant tends to be very different. Dutch funds seem to have much more freedom to make their own decisions."

Ironically it is countries such as the Netherlands which have regu-latory systems which should make allocation to alternative assets much more difficult. The FTK system posits a rigid link between short term solvency and funding adequacy, ignores the timing of projected cashflows, and requires funds to mark their assets to market and then match them with an artificially arrived at Net Present Value. Many have pointed out the obvious illogicality of this system, as well as the trifling matter of it appearing to be in breach of the European Pensions Directive, which prohibits any regulations which would force a pension fund to reduce its equity holdings below a certain level.

Other countries, such as Sweden and Denmark, have introduced similar systems under the traffic lights regime. Incidentally, pensions expert Con Keating predicted in 2006 that the long term cost of complying with FTK in turbulent market conditions could be equivalent to 10 per cent of Dutch GDP, so it will be interesting to see how this plays out now that such market conditions may be upon us.

The UK regulator, by contrast,
is thought to be sympathetic to the idea of Multi-Asset Class allocation policy; Barclays Bank's pension scheme, for example, is pursuing something close to the idea of the Yale model. Railpen also has high allocations to alternatives, albeit without coming anywhere near Yale's 65 per cent. Yet ironically it is among UK plans as a whole that we find probably the lowest overall alternative investment figures in the world. Clearly, then, whatever people may say to the contrary, differing regulatory frameworks do not appear to be a major factor.

Nonetheless, those who have addressed trustee meetings will attest to the fact that there is widespread ignorance about the true level of liabilities, and in particular a total failure to understand that IAS19 does
not seek to calculate these. "Pension trustees, con-sultants and regulators should not rely on IAS19 and FRS17 figures for invest-ment strategy purposes," says Alan Kirkpatrick of the Kirkpatrick Partnership who recently argued this very point in a lengthy article in Journal of Pensions. Itis observers such as Kirkpatrick who point out what should be obvious, but gets overlooked: IAS19 produces an artificial figure for the financial accounting purposes of the sponsor, not a genuine pre-estimate of liabilities for trustees.

Some cynical observers suggest that plan sponsors are happy to encourage trustees in this mistaken belief, particularly where the scheme is already showing a deficit under IAS19, and that this process is facilitated by them ensuring that the company's own pension consultants also advise the pension scheme. Interestingly, this glaring conflict of interest has been largely ignored by the UK Pension Regulator's recent consultative document. It is also unclear why the asset allocation and manager selection advice which consultants give is not 'investment advice' for the purposes of registration with the FSA, which would provide another avenue to regulate these conflicts.

The overall picture which emerges, then, is of continued strong demand for alternatives in the US, but of relatively low interest in Europe, which is growing only slowly. Moreover, there is increasing polarisation in attitudes towards alternatives. A JPMorgan survey released in November last year showed that those institutions that are already invested in alternatives are generally planning to increase their allocation levels, while those that have never taken the plunge overwhelmingly believe their decision to have been correct, and show no signs of wanting to change it.

So much for the past– what of the future?
The JPMorgan survey referred to above also suggests that it is ‘real assets’, i.e. excludingprivate equity and hedge funds, where pension funds feel most comfortable. This is reflected in the annual WM survey of UK pension funds, which have shown a constant though low amount invested in real estate (usually about six per cent), at the same time as almost nothing in the other two main alternative classes.

However, most European pension funds, certainly those in the UK, seem to feel that there is little need to increase this figure further. This seems strange given evidence suggesting that UK property exhibits low correlation against the FTSE, and that an explosion in the availability of property funds has addressed the traditional problem of access.

Private equity observers expect a short term fall in the inexorable rise of fundraising numbers as the outlook of some (though by no means all) institutions is made more cautious by the credit crunch.

The more sophisticated, such as Alpinvest, have already stated that they will not be changing their commitment plans. Long term, there seems little doubt that the industry will continue to grow.

Hedge funds have traditionally banked on pension funds and their consultants clinging to the traditional, but now largely discredited, view that volatility and risk are one and the same. They have thus been able to sell their products to pension funds on the basis of reducing overall volatility within their portfolio, and thus achieving a better risk adjusted return. The irony of investors paying a higher fee for a lower absolute return is yet another manifestation of the unreal world inhabited by the European pension community. However, these claims will now be put to the test as many investors may start to experience exactly the sort of market turbulence that these products are designed to nullify.

Investors may be in for an unpleasant surprise. Many market neutral hedge funds have sought to reduce volatility not by selecting lowly correlated assets, but by going long and short in different stocks within the same sector. Yet few are able to take a genuine long term view, at least not without the cost of having constantly to renew derivative positions. Even if they could, if stocks begin to move in unpredictable ways then the need to close threatening long positions could become overwhelming. There is hearsay evidence that this may be happening already, and helping to contribute to exactly the market volatility that these products were supposed to address.

It is possible that investors will seek different ways of accessing hedge fund type returns. ETFs, for example, “offer a fast, liquid and low cost way of gaining access to a whole range of underlying assets, from commodities to equity indices,” argues Deborah Fuhr of Morgan Stanley. Then there is the whole issue of replication, over which the battle lines are already being drawn.

Only one prediction can be made with any certainty – the great alternatives debate is set to run and run.

Written by Guy Fraser-Sampson author of Multi Asset Class Investment Strategy