

Current affairs

HEAD TO HEAD: Hedge funds are fast becoming a key strategy in pension fund portfolios.

Hannah Williams asks to what extent hedge funds can benefit various types of schemes

- 1** Is hedge fund investing suitable for all pension fund investors or are there size limitations?
- 2** Are UK pension funds making high enough allocations to hedge fund investments?
- 3** How integral are hedge fund strategies to helping pension funds to match liabilities?
- 4** To what degree do regulatory burdens prevent pension funds from exploiting hedge fund strategies?

“Diversification across all asset classes is integral to reducing volatility and enabling a scheme to match liabilities”



Harry Wulfsohn
Director
Stenham Advisors

- 1** The evolution of the hedge fund industry has given all asset managers, including pension funds, another important tool to help improve the overall diversification and reduce volatility in their portfolios. In this context, an allocation to hedge funds is important for all pension funds; even a relatively small allocation can have an impact on reducing overall volatility. There is approximately £500bn invested in hedge funds globally, including very large allocations from certain US institutions and endowments, and we believe all pension funds, inclusive of the very large schemes, should allocate a portion of their portfolios to hedge funds.
- 2** Compared to US institutions, which have been investing in alternative assets since the 1970s, UK pension funds have much lower allocations, having only begun looking at alternatives in the last 10 years. The pension fund industry in the UK is, in the main, still at the information-gathering stage – understanding the big picture and the role hedge funds and other alternatives have to play in their portfolios, and generally educating themselves. However, there is a wide range of allocations being made by UK schemes from nil to above 30% and we expect this trend to continue as trustee awareness and knowledge grows.
- 3** Hedge funds are one of a range of assets that should be included in a pension fund portfolio. Diversification across all asset classes, including both traditional and alternatives, is integral to reducing volatility and enabling a scheme to match liabilities. Hedge funds constitute an ideal diversification in the context of liability matching, as they can be expected to produce both inflation-beating returns and reduce portfolio volatility over the long term. Factors such as the size of the liabilities and the time frame will clearly impact the ultimate allocations with higher allocations to hedge funds and bonds, where the scheme cannot afford to be exposed to the more extreme volatility of equity markets.
- 4** The regulatory restrictions imposed on pension funds are no more onerous for investments into hedge funds than in any other asset class. Any ethical restrictions, for example, would be the same for equities as for hedge funds.



“Hedge fund returns are typically cash-like in nature and, in a conventional sense, they are a poor match for liabilities”

George Henshilwood
Partner
Hymans Robertson

1 I don't think size is much of an impediment to investing in hedge funds. We would only recommend a fund-of-funds approach to ensure diversification. Pooled funds-of-funds are available for most strategies and the minimum size is not really an issue. However, there are two potential impediments: if the trustees wish to impose restrictions which mean that a pooled approach is not suitable, the minimum size for a segregated mandate might be £20m (equivalent to 5% of a £400m fund); secondly, smaller funds are perhaps less well equipped to deal with the governance issues around making a number of small allocations to different asset classes.

2 It depends on the level of confidence we have in hedge funds to deliver consistently to, say, a Libor plus 4-5% benchmark. We have been at the more sceptical end of that assessment – concerned about the levels of fees, the ability of hedge funds generally to meet return targets as the amount of money under management has risen exponentially and the fact that a number of hedge funds represent inappropriate strategies for pension funds given potential levels of gearing and underlying investments that may be compounded by lack of transparency (although we accept that fund-of-funds managers can help in this). So, our observation is that the allocations to hedge fund are quite modest and that this is appropriate, given our concerns.

3 Hedge fund returns are typically cash-like in nature and, in a conventional sense, they are a poor match for liabilities where the value of these liabilities is driven by bond yields and inflation expectations. They are a better match where funds have entered into swaps to take out the interest rate and inflation risk and where the pay side of the swap requires the fund to generate Libor.

4 I don't think regulation is an impediment. Some trustees will find some issue with the unregulated nature of hedge funds and the fact that most are domiciled in locations such as the Cayman Islands. Clearly there is some requirement on trustees to understand the nature of the vehicles in which they invest; this can be difficult in some hedge funds where transparency is an issue. Equally, where there is transparency, trustees may find it difficult to accept the levels of gearing that some funds use.



Lindsay Tomlinson

Keep an eye on the US model

The various reviews on the future of the UK pensions system have looked at a variety of systems run in other countries for lessons; the systems in Sweden, Australia and Chile have been thought worthy of study.

Of course, 401k in the US has always attracted attention, but now there have been further developments in the US which have important implications for national pension arrangements elsewhere. The area that interests me most in this respect is the strategic development of defined contribution (DC) pension funds.

So, as ever, one needs to look to the US to discover trends that are likely to be replicated elsewhere. Take, for example, the economics of personal account recordkeeping. As 401k developed, many of the consultancies went into recordkeeping, looking for income to replace possible losses in actuarial business. But the record-keeping business is capital intensive and has commoditised. It doesn't look a very attractive business opportunity to me. And now its economics are under further threat, as the big mutual fund companies use it to develop their retirement rollover and retail investment businesses. This is likely to happen elsewhere.

On the legislative front, the US Pension Protection Act (PPA) has encouraged plan sponsors to go boldly with their DC plans in ways that may gain traction elsewhere. The three key elements are auto-enrolment, auto-increases and auto-default.

What are the main perceived deficiencies with DC plans? There are essentially three main problems: getting people to participate; getting them to contribute enough; and ensuring appropriate long-term investment strategies, ie avoiding the “reckless conservatism” of very low risk investment options. The PPA seeks to address these problems by establishing appropriate default positions and letting inertia work its magic.

First, people will be encouraged to participate by permitting auto-enrolment. They will automatically participate unless they make the conscious choice to opt out. Second, the amounts they contribute will be kept current and sufficient by auto-increases – the contributions will increase each year unless the participant consciously chooses not to increase them. And third, sponsoring employers will be given a safe harbour for default investment options that satisfy necessary conditions to enable them to be classified as qualified default investment alternatives (QDIAs). This will facilitate defaulting participants into suitable long-term investment strategies, such as life-cycle investments.

These are significant changes to the US pensions system and they are already having a major impact. As I indicated earlier, 401k has been the world's leading personal account system. The changes facilitated by the PPA will enable it to push on again. This will provide a very interesting example for other countries to observe and likely seek to emulate.

Of course, other countries continue to provide lessons of both good and bad pensions practice. I am sure the incoming chairman of the UK's Personal Accounts Delivery Authority (Paul Myners) will have noted with interest the problems arising from the loss of 50 million pensions records in Japan. We would be well advised to learn every lesson we can from other countries when thinking about the future of our own pensions system. ‘Not invented here’ should be a positive, not a negative.