



THE LAST WORD PHILIP COGGAN

Finding new ways to mix and match

Some advisers say pension funds should put the growth portion of their portfolios into a much wider range of assets

Equities are not the only growth asset. The UK investment community is starting to catch up with this idea, which was pioneered by forward-thinking institutions such as the Yale endowment fund.

Kevin Frisby, investment consultancy director at HSBC Actuaries and Consultants, proposes that pension funds should allocate the growth portion of their portfolios from a much wider range of assets. He starts from the assumption that the mature portion of the portfolio – pensions in payment – should be matched with government bonds and cash. Medium-term liabilities can be matched with corporate bonds and other “duration-based strategies” such as swaps.

Traditionally, the UK pension fund industry has tended to be structurally underweight in these assets. They have had a far greater weighting in equities (over 80 per cent at times) than their maturity profile should suggest.

The argument in favour of equities is that they deliver a “risk premium” to investors over the long-term. This premium compensates investors for the short-term volatility. Pension funds, it has been assumed, can afford to ride out this short-term volatility because of their long-term perspective. This argument had an appealing corollary, of course; by assuming a higher long-term return, actuaries allowed sponsoring companies to reduce their contributions.

Another way of looking at the issue is to say that long-term liabilities have a real component; they will go up in line with wages, which should rise a couple of per cent faster than inflation.

Equities are a real asset, since corporate profits should keep pace with the economy over the long term. Furthermore, they have demonstrated the ability to produce positive long-term real returns.

But they are not the only asset that should do so. Property is another real asset, since land prices and rents should keep pace with the economy. Commodities also have a case, although until recently there seemed to be a long-term downtrend in real raw materials prices. Private equity is just a higher risk-return version of public equity. It is arguable whether hedge funds have a “real” component but, with their absolute return focus, they should help reduce the downside risk.

Mr Frisby adds in high-yield bonds to create a diversified growth portfolio in the following proportions: global equity (40 per cent), property (15 per cent), hedge funds (15 per cent), commodities, high yield and private equity (10 per cent each). Sticking to these proportions over the longer term should allow the portfolio to benefit from rebalancing effects (selling overvalued and buying undervalued assets).

Mr Frisby claims that a combination of these asset classes can reproduce the equity risk premium. Obviously that is true of the global equity portion and one might even get a

bit more out of private equities. But one would expect the remainder of the portfolio (hedge funds, commodities and high yield) to get a bit less than equities, and a bit more than government bonds. Realising the full equity risk premium will thus depend on the ability to generate “alpha” – outperformance by individual fund managers. This may be possible for individual pension funds but is clearly not possible in aggregate.

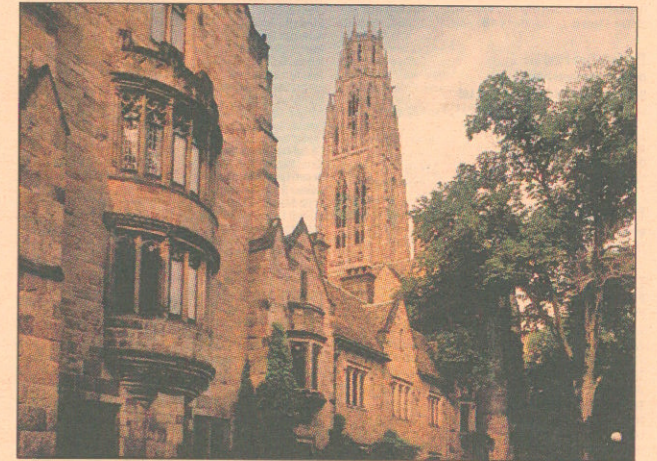
Nevertheless, an approach along these lines seems more likely to generate superior risk-adjusted return than global equities alone. Commodities have a negative correlation with global equities on a quarterly basis, while high yield has a negative correlation with property. But it will not necessarily generate a higher total return than pension funds currently achieve. And that will be of no comfort to trustees struggling with substantial deficits.

There is also room for argument about which alternative assets should be selected and in which proportions they should be combined.

Frontier Capital Management is in the process of launching a total return fund, aimed largely at high net-worth investors but with an institutional share class. It has a benchmark asset allocation of global equities (22 per cent), global bonds (25 per cent), emerging equities (5 per cent), emerging bonds (5 per cent), real estate (15 per cent), commodities (8 per cent), hedge funds (15 per cent) and managed futures

(5 per cent). Back tested since 1991, this has produced an annual return of 9.9 per cent (compared with 10.1 per cent from the FTSE 100) with a standard deviation of 5.9 per cent (Footsie 14.1 per cent) and a worst 12 month return of minus 7.3 per cent (Footsie minus 29.8 per cent).

Clearly, lots of fund managers are now looking to provide this kind of fund or service. Over time, competition should produce the best models. And that must be in the interest of clients.



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