What do pension funds want from their investments in today's markets?

For the average pension fund, developing a successful investment policy can be a challenge in good times. And for most of the UK's occupational pension funds, these are far from good times, writes **Matthew Craig**

Sovereign bonds, which were once an anchor for investors, are now dogged by uncertainty as the Eurozone debt crisis rumbles on. Equities are volatile, with huge swings in values on a regular basis, which makes life hard for risk-averse pension funds. Other asset classes may not offer the diversification they promise; the global financial crisis of 2008 showed how all correlations turn to one in extreme conditions. And hedge funds have not proved reliable in generating positive returns in all markets, as they purported to do.

So many pension funds are now reassessing investment strategies in the light of today's erratic and unstable market conditions, in order to ensure they can preserve their wealth and obtain the returns they need. Mercer partner Christian Hardy commented: "Given the immensity of the tasks of deleveraging Western economies, resolving the Eurozone crisis and coping with a weak economic outlook, where markets may well continue to be spooked easily, pension fund trustees and sponsors will need to stay alert as conditions could change quickly."

De-risking

For most UK private sector pension funds, de-risking is now the name of the game and many are planning how to gradually de-risk and improve funding until liabilities can be settled with a bulk annuity transaction. However, extreme market volatility can disturb these plans. Standard Life Investments Head of UK institutional business and consultant team, Louise Kay, commented: "Most pension plans

Christian Hardy,
Partner, Mercer

have their flight path in place and have triggers for when they will put protection in. After the volatility this year, many funds will be in a position where they have not yet reached the trigger so funds could well be revisiting what to do next."

Liability-driven investing (LDI) has developed as a way to de-risk and it usually means holding fixed income assets to match pension liabilities and some return-seeking assets in order to help close any funding gaps or maintain a solvency buffer. Phil Page, Client Manager at solvency manager Cardano, commented: "There is a general, long-term creep towards LDI, which continued this year. LDI is one of the best ways to stabilise the funding position, so assets move in step with the liabilities that they are protecting against." Some schemes have been reluctant to adopt LDI because it means locking into bond yields which are currently seen as being very low. According to Mercer's Hardy, schemes which have waited for this reason are likely to have lost out: "Trustees who have put in place asset or liability management structures will have fared better in the downturn than those who have not."

For UK pension funds, which have traditionally been equity investors on a significant scale, adopting an LDI strategy usually means cutting equity allocations, but this has been happening anyway. Page said: "There is definitely diversification away from equities and towards hedge fund strategies, but it is very gradual. Allocations to high yield debt and emerging market debt, among other asset classes, are increasing as people no longer see equities as their sole exposure to the markets". This means that UK pension funds are becoming more sophisticated investors than in the days when they had a 60:40 or 70:30 split between equities and bonds. By investing in a range of assets, they are gaining exposure to a variety of market returns, or beta, rather than just equity returns. However, greater diversification and the use of new asset classes can ask questions of the ability of pension fund trustee boards. In particular, do they have the time and resources to monitor more fund managers, and ensure the investment strategy is working as planned in a tough investment climate? Hardy commented: "Success in volatile conditions will require speed and flexibility when changing investment strategy or taking advantage of opportunities to reduce risk. Those trustee boards with sufficient time and resources should consider establishing rapid response sub-committees which can convene and respond swiftly to events".

Alternative options

Investing in alternative assets, such as private equity, infrastructure and property, could also help schemes move away from equities and reduce risk. SLI's Kay commented: "There is a huge trend at public and private sector funds for alternative growth strategies". She added that some local authority pension funds are now going cash flow negative, as many private sector funds already have, meaning outgoing pension payments now exceed income contributions. "It means funds are more concerned about inflation and have a need for income. Depending on the size of the fund and their governance, they may be prepared to take on illiquid assets that generate income, such as infrastructure, or real estate", Kay said.

Some alternative assets are designed to cope with falling markets and turbulent times, such as macro-oriented hedge funds. Page commented: "Funds which have looked to make decisions on macroeconomic factors have done very well this year and last. Tail risk hedging funds, based on option strategies, don't make much money in good times, but in bad times when equity markets are falling, they can expect to make a lot of money. Some tail risk strategies have made reasonable returns over the long-term and excellent returns when most other asset classes are falling."

As well as using alternative assets, pension funds are increasingly exploring the wider reaches of the fixed income universe, from inflation-linked bonds, through to emerging market debt and various kinds of corporate finance. M&G Investments Head of Institutional Distribution Bernard Abrahamsen said that a big, unwritten story in 2011 was that many pension schemes did far better than the newspaper headlines would suggest. "The key to surviving 2011 was to sit tight in secure corporate bonds such as asset-backed securities – the sort that require a 50 per cent fall in house prices to interrupt their income stream. Many of these bonds provided more than enough protection. Then, as markets unravelled over the summer, the time was right to start inching up the risk spectrum. Many high-yield bonds offered astonishing returns with very high levels of security. When investment markets are gripped by panic the patient investor is almost always rewarded".

For pension funds seeking steady incomes without undue risk, investing in funds that offer loans to good prospects could be one option. This market is seen as opening up to institutional investors, because the banks, which used to provide this facility, are retrenching and may no longer be able to offer credit as freely as they once did. M&G has recently set up a social housing debt fund and this aims to generate an income for investors at around two per cent above UK inflation, as measured by the Retail Price Index (RPI). M&G Director of Fixed Income William Nicoll said: "Social housing is a natural lending opportunity for any pension fund or insurance company that wants an inflation-linked income for the long-term. Institutional inflation liabilities dwarf the assets available, namely the £329bn UK index linked gilt market, and so they must consider alternatives – in social housing they have a sector that also needs long-term finance."

Building in infrastructure

Another option for pension funds looking for a secure income stream is infrastructure. This consists of owning assets which are part of a country's infrastructure. This covers transport infrastructure, such as roads, airports, railways, ports, or utilities, such as water or energy assets, or social infrastructure, such as schools and hospitals. Certainly, the UK government wants to see more pension fund investment in infrastructure and it has recently announced steps to work more closely with pension funds in order to encourage more infrastructure investment. For pension funds, the price and the terms of any infrastructure investment have to be right and there is a feeling that asset managers have not offered the right opportunities. Pension funds see infrastructure as a low-risk, long-term asset with a steady income attached and have complained that managers have only offered them relatively short-term investment vehicles, with more risk and higher charges than they want. The very biggest funds may be able to invest directly, for example, a consortium of large Canadian pension funds recently bought the UK's high speed one rail link, but most funds cannot do this and need to invest via suitable funds. If pension fund demand can be met, then infrastructure could play a vital role in helping pension funds de-risk while still generating an income. Abrahamsen commented: "Infrastructure could well be another big story in 2012. Irrespective of the UK government's laudable attempts to boost pension fund investment there are already some attractive opportunities out there. However, these are more likely to be in well run, established, operational assets like transport or energy transmission, rather than green field developments."

Sometimes, the simplest investment strategies are the best and a final thought from Cardano's Page is that UK government bonds have proved a good asset recently. "People are not sure about the Euro zone and some are nervous about equity markets, so there have been great returns on UK government bonds right now. Yields have been pushed down to record levels as the price has risen very significantly. Investors tend to think of bonds as a hedge for liability risk, but in the last year they have been giving great returns in their own right."

For UK pension funds, these may be challenging times, but there are various investments could help bring them both security and returns. The difficulty for some will be sorting the wheat from the chaff, when assessing possible solutions and outside experts, such as fiduciary managers may be asked to help with this. Nevertheless, there is a sense that pension fund investors are rebuilding their portfolios after the shocks of the last few years so that they can cope with an uncertain future. ■

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