INVESTING IN ALTERNATIVES, EUROPE 2015

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Exploring the drive towards alternative asset classes and investment strategies by European based asset owners and the opportunities that have emerged

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CONTENTS

Investing in Alternatives, Europe 2015

George Finnie
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Vicky Hudson
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Roy Kuo
Team Head - Alternative Strategies, Church Commissioners for England

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Managing Director, Edgehaven and Investment Adviser, Royal Mail

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SECTION 1

RETHINKING THE ROLE OF ALTERNATIVES

1.1 INTERVIEW

Thinking more holistically between growth and tail risk protection

1.2 INTERVIEW

Active versus passive alternatives – is there a suitability criteria or is it a cost argument?

1.1 INTERVIEW

Thinking more holistically between growth and tail risk protection

Interviewer

Noel Hillmann
Managing Director, Clear Path Analysis

Interviewee

George Finnie
Investment Manager, Strathclyde Pension Fund

Noel Hillmann: Would you please explain whether you seek to manage tail risk internally, across your portfolio, or outsource risk to an advisor/investment manager?

George Finnie: I run the 'new opportunities portfolio' for the Strathclyde Pension Fund. This is the Fund's alternatives portfolio, so it covers areas like renewables, infrastructure, credit, housing, some property, etc. It is a wide raft of different sectors and opportunities. Fundamentally, we run the SPF and don't have an advisor or fund manager looking after it. We invest mainly in funds but, to some degree, directly where we have the resource or expertise to do it.

In terms of looking at risk, all risks are part of our assessment and we do a very detailed risk analysis before we go in. We decide what risks we think are relevant and we maintain that analysis throughout the course of our involvement in any investment.

Noel: How do you differentiate and look at the issue of short-term volatility risks and the long-term risk of failing to generate the growth required from your investment strategy?

George: Given the types of investment we make, volatility is not the main issue. If we invest in, say, a wind farm or solar energy then there is an element of volatility due to the weather – and that is out of our control – but it is not a market-type volatility, rather it is due to the inherent nature of the asset. Things like infrastructure investments tend to be less volatile. Some of the other areas we invest in do have some degree of market volatility but much less so than the public equity markets. The point of what we are trying to do is to invest in areas which don't get locked into market volatility to the same degree and where it is managed within the context of a long term approach to these assets.

Taking the long-term risk of generating growth, we have risk reward criteria and are investing in products and sectors that we believe will deliver adequate growth to build the levels of return that we need to produce the benefits that our members are due. As a fund, we currently don't plan to be investing in the equity markets to the same degree and if you go onto our website you can see our longer-term strategy – a gradual movement away from equities and into areas like infrastructure and credit, which are both long-term and enhance yield. We are looking at things that will give us a fairly defined, but not necessarily stratospheric, level of return; and we are trading away volatility and potentially higher overall returns for a greater degree of certainty.

Noel: Would it be fair to say that you don't consider short-term volatility risk whatsoever, when you are looking at your alternatives portfolio, because you have a long-term liability horizon?

George: Yes, we do have a long-term horizon so we are investing in most of these for a longer-term than even 20-25 years, in some cases; but there are things that do get hit by short-term volatility. In renewables, part of the return of what a wind farm or hydro plant will get you will be government subsidy and, as things stand, once you are in a subsidy tariff you will remain there for the remaining term of the relevant tariff. Part of the income is under a Power Price Agreement related to the electricity market so there is some degree of short-term risk associated with those types of investments.

Part of what we have to do, then, is take a view on how big a component this volatility is going to be in terms of what markets are saying and see what the fund we are investing in is doing to try and smooth out that risk and address the issues there. It does also depend on the sector as, just because we are investing in long-term assets, it doesn't take you away from market risk, but it does reduce it in part.

Noel: The definition of 'tail risk' has changed since, following the crisis, it increasingly gets applied to 'rare events'. How significant is your allocation to hedging against the unknown unknowns?

George: A lot of people define tail risk in different ways. My portfolio is fairly well diversified since there are a wide raft of assets and sectors included. Even within that there are various sub-sectors so if you take, say, renewables you've got, within that, solar and wind which are both fluctuating types of energy generation, but you also have things like biomass which are much more base-load friendly.

It's effectively hedging – spreading the different investments into different types of renewables. If you take that sector, one potential tail risk is if the

government decided to retrospectively take away all subsidies on renewable energy – which is a very unlikely event, but could happen – so you have to take a view on that and consider why it would or wouldn't be likely to happen.

Noel: How do you balance the portfolio to make sure that you have that tail-risk protection built in?

George: We have a well-diversified portfolio so renewables is only a part of the picture and only part of one asset stream, so we wouldn't be losing money through the impact of a tail-risk situation, though we wouldn't be making a huge return.

Noel: The allocation, then, is so small that it would make no difference on its own?

George: No material difference.

Noel: How do you approach the subject of preparing for the unknown unknowns? Is it something that comes up regularly and how does it get discussed?

George: It comes up regularly for me in that new opportunities and investments go through a number of different committees and issues will get raised at different levels. Since many of the asset classes in which we invest have been new to the fund, and therefore to the committee members, there is a significant focus on what can go wrong! Our analysis is all about what the main risks are, what likelihood there is of these occurring, and how can we/the manager try and prevent those problems. Part of this is about research and getting to know what the marketplace is all about; all of these investments are in very specific markets and there is a lot of research out there. We try and avail ourselves of as much of that as possible.

We also ensure that we explicitly cover off as many potential risks as we can in our assessment process. The more you invest in particular areas, and are aware of issues that come up on a regular basis in terms of what the perceived risks are, the more you are prepared for the possibility of unexpected eventualities. This means that whilst we can't cover the unknown element which can come out of left field – and can happen to us all, we can make sure that what we have in front of the committee is as robust as possible, covering off all of the obvious and material risks.

Ultimately, it is about ensuring that we are dealing with the right people who will be able to react to things that come out of left field, and are well-versed in the industry and have some degree of ability to deal with issues as they come along. It is more granular than some of the equity mandates that we have in that you are dealing with people who are, to some degree, much more operationally hands-on; so you need to be sure that they can make decisions and work things out if things do go wrong.

Noel: How do you continue to monitor and stay realistic about the true tail risks?

George: We are continuing to develop the monitoring governance on an incremental basis as we go along. Obviously, as the new opportunities portfolio grows and gets bigger, we take more of a structured approach in terms of looking after involvement with the various underlying funds and investments.

We always try, where possible, to take up positions on advisory committees or boards that are involved with any of the funds. This way we can get as much information as possible on anything that we are involved in. The more you know, and the closer you are to the fund and the people, the more likely you are to see an early warning sign and also get a much clearer idea of what the individuals involved in the fund and transactions are like. Information is key and having access to the individuals who are involved in the fund and transactions is important to us. From a legal perspective, we are limited partners in our funds; so we can't be actively involved in the running of them, but we can try to be involved in other ways.

Noel: Thank you for sharing your views on this subject.

1.2 INTERVIEW

Active versus passive alternatives – is there a suitability criteria or is it simply a cost argument?

Interviewer

Margie Lindsay
Editor, Alpha Journal

Interviewee

Roy Kuo
Team Head – Alternative Strategies, Church Commissioners for England

Margie Lindsay: How many people do you have in your team?

Roy Kuo: I head up alternative investment allocations for the Church of England's endowment scheme as part of the wider investment team which manages our endowment fund to support the work and mission of the Church of England. We are a large diversified portfolio of about £7bn of assets.

Margie: What role do alternatives play in your investment portfolios? What types of alternatives do you allocate to? Why those?

Roy: We consider alternatives as part of the Commissioners' overall efforts to maintain a diversified portfolio. That includes other things like equities, private equity, property, timber, etc., so what we are looking for is a diverse group of return generators that can help the endowment support the Church of England's mission to be a Christian presence in every community.

Alternatives can refer to a wide group of assets, for example multi-asset funds or credit strategies and the like. We generally allocate to things that would be considered more liquid tradable strategies or illiquid longer-term strategies. These can include multi-strategy, global macro and credit funds.

Margie: Do you invest in property, infrastructure, impact investing or similar?

Roy: We have a large and diverse property portfolio which makes up just under a third of the overall fund, less in infrastructure but more in timber. Indeed, the Church Commissioners are the largest private forestry owner in England. Property is a strong investment for us as we can generate additional value through long-term active management to help us meet our Retail Price Index (RPI) plus 5% target to continue to make distributions to the church to meet its funding needs.

In terms of impact investing we do not do social impact investing but the environmental benefit is one of the elements that makes timber very attractive. Growing trees does take time but this suits us very well in that we do have a long time horizon in the way that we evaluate investments; and so if trees take 20 years to grow that works well for us. Hopefully this can also help in sequestering carbon emissions and assist the furtherance of our climate change policy as well.

Margie: Looking at the entire portfolio, how do you decide your allocation strategy?

Roy: We do have thresholds but we do set them fairly wide as what we don't want to do is have a silo mentality whereby each person becomes responsible for each asset class. We try to look at the portfolio more holistically in terms of how we manage it in order to maintain balance between the constituent parts. If we want to invest in, say, real estate or private equity, these investments take a longer period of time to realise. We will take into consideration how much liquidity we need within the portfolio in order to meet our liabilities and then decide how much we want to invest into less liquid assets to capture the illiquidity premium. It is always a balance.

Margie: What internal operations at your fund is critical for allocating on an active basis to alternatives?

Roy: We invest in quite a bit of property and timber directly since, being the Church, we have had a lot of this passed down through the generations; so we have a direct team that is responsible for managing that. With the other parts of the endowment, we have people who are dedicated to the equity and alternative sides. I don't see alternatives as a bucket in itself. What I look at are the types of strategies which can provide diversification from our equity and real asset portfolios.

Margie: Do you do everything in-house or do you use external managers?

Roy: We hold most of our property and timberland portfolio directly, but outside of this almost everything else is via managers. We feel that this is a much better way to manage things because then you can seek out the best manager in a particular area and invest with them rather than trying to hire every team in-house. We have a rigorous selection and monitoring process for our managers.

Margie: Has the way you manage and view your portfolio changed since the financial crisis? Do you feel that active management is now needed because of Quantitative Easing (QE) and government policies?

Roy: There is always a case for active investing but it is just less evident

during the strong bull market that we have witnessed over the past couple of years. Europe and the U.S. had equity and credit markets which went up quite a way and it is much more difficult for active managers to differentiate themselves in those types of market conditions.

In the current environment where things are moving much more sideways, a manager would be able to do a much better job of protecting the downside whilst generating alpha. In this case we do feel that an active manager should outperform the market. Historically we do find strong evidence of this.

Margie: Is any part of your portfolio passive management?

Roy: I wouldn't say that anything is passive. There are certain areas where we feel there isn't much alpha to be generated, larger-cap equities for instance, where we look for a lower cost and a more passive way of gaining exposure. Overall, we still look at everything very actively because we need to in order to hit our return target.

Margie: How do you differentiate between managers? How do you make the choice of which manager to use?

Roy: It is a combination of deciding whether we feel that we are being rewarded for the risks that we are taking and whether the return is commensurate with what we need to achieve in order to hit our return target. We also need to take into account the ethical elements of our policy so that we invest in alignment with the values of the Church of England.

Margie: Is it liability-driven investment or do you have to hit a certain return target each year?

Roy: Our return target is RPI plus 5% over the medium term; so we try to achieve this but, obviously, you have to take into consideration what is occurring in the markets. It is not absolute that this will be achieved every year but we have achieved this over the last 30 years.

Margie: What is more important to your focus: ethical and social concerns or generating the best returns?

Roy: We benefit from advice from the Church's Ethical Investment Advisory Group and have ethical policies covering all parts of our portfolio. Our newest policy is on climate change which required divestment from direct investments in thermal coal and oil sand fossil fuel companies.

We look at what managers are doing and decide if they meet our guidelines. This isn't just about exclusions; but more philosophically as to whether what they are doing to generate a return is something that we agree with.

Margie: Have you found managers are prepared to follow your ethical requirements?

Roy: We do push on this and not everybody in the asset management industry is the right fit. Ethical requirements are part of our due diligence, so we consider these factors and have a screening process where the ethical element is incorporated. We do that on a traffic light system so that if the manager doesn't meet certain qualitative and quantitative thresholds then we can't invest with them.

Margie: Do your allocations to each asset class vary a lot each year or do you allocate over a longer period?

Roy: We would never make a massive change in any particular year and tend to move more incrementally. If we feel that one sector is more attractive than another we would add mandates in the former and start to pull capital from the latter; and this works fairly well for us.

We are constantly looking for better sources of return than what we have in our existing portfolio. If we feel that something is complementary to what we already have in the portfolio then we will allocate to that and pull from something that is less attractive.

Margie: Thank you for sharing your views on this topic.

SECTION 2

CHANGING GOVERNANCE STRUCTURES AND DIVERSIFICATION

2.1 ROUNDTABLE DEBATE

How esoteric or alternative should investors be with their allocations or is the aim to simply diversify from equity and credit risks?

2.2 INTERVIEW

Manager diversification and appropriate ways to access to alternatives – fund of funds, partnership structures, advisory approach or via Diversified Growth Funds

2.1 ROUNDTABLE DEBATE

How esoteric or alternative should investors be with their allocations or is the aim to simply diversify from equity and credit risks?

Moderator

Hubert Danso
Chief Executive Officer and Vice Chairman, Africa Investor

Panellists

Antony Barker
Director of Pensions, Santander

Bev Durston
Managing Director, Edgehaven and Investment Adviser, Royal Mail

Anders Thorendal
Chief Investment Officer, Church of Sweden

Hubert Danso: Thank-you for joining me on this debate today. What is the panel's current allocation to alternatives and what is the role of alternatives in your portfolios?

Antony Barker: About 2 or 3 years ago we took the decision to move increasingly into what we see as real assets and private markets; we felt that the volatility of quoted markets was an unnecessary volatility and not obviously rewarded. We also looked at our profile of liabilities and realised that our cash flows peaked at around 20 years out, so we were unnecessarily holding liquidity within the fund and could utilise any liquidity premium better.

However, we quickly came to the conclusion that the liquidity premium had largely been priced out of the market for assets and that it was a complexity premium that was left on the table. This directed the nature of the assets that we were looking at towards more physical assets or businesses with embedded value that would need working on for anything up to 7-10 years, and might need bolt-on acquisitions or other restructuring.

These would probably be in a mid-market space that was potentially deemed 'too small' for the sovereign wealth and other large international institutional funds, but these would be an obvious exit route for us. In terms of buying stuff on a bilateral off-market basis, there are often good reasons why the vendor wouldn't want it known that they were having to raise liquidity and actually we could get much better pricing and a much better deal than we might otherwise.

We hold about 30-35% in real assets in private markets and our quoted equity exposure is down to about 20% and falling. We are fairly agnostic in terms of the sub-class divisions, since we often see quite a blurring between private equity-based capital, infrastructure, real estate and debt. We tend to pick a theme and try and identify what the asset class or opportunity is that will best get us exposure to that; for example, our acquisition of the Manchester Arena was based on an entertainment theme, i.e.what really drives inflation, in that we were seeing people spending more and more money on concert tickets and experiences in volume and speed and have now gone on to develop another portfolio of assets to play on that experience theme.

Another theme might be 'emerging middle classes in Africa and Asia'. This phenomenon is changing the diets of millions of people and we are working on a number of themes for playing natural resources, food, or other related strategies that will pick up with that increase of demand for the market. Energy would be another element, not just in generation but also in consumption and transmission. A number of the strategies that we have in South America are looking at distribution of US-generated shale gas over a wider sphere.

It is a fairly diverse portfolio and the most recent acquisition would be a portfolio of marinas; we didn't believe the Steve Webb [former UK government Pensions Minister] comment that people would cash in their pension pots for Lamborghinis but would, instead, do what they have always done and buy yachts – and those yachts need to be housed somewhere. Interest in Ben Ainsley's America's Cup bid will only add to the demand.

Hubert: Would you regard car parking assets as a platform that could fit within your unique approach? Also, could you give us an indication of how large your fund is?

Antony: The fund itself is a shade under £10bn: we have grown it by a couple of billion in the last couple of years, but we still have a long way to go. If you take the discounting off, we have made £26bn of future pension promises, however you want to value those, so we are going to have to invest a lot over the next 10 years to catch up with that. As for the car parks, we do have a lot of them already.

Hubert: Bev, what your current allocation to alternatives and what is the role of alternatives in your portfolios?

Bev Durston: The role of alternatives in our portfolio is to clearly diversify from equity risk and credit risk which are present in the rest of the portfolio. I advise on the Royal Mail pension plan and my company, Edgehaven, also advises other clients here in Australia.

"The role of alternatives in our portfolio is to clearly diversify from equity risk and credit risk"

In relation to Royal Mail, the portfolio is around £6.5bn and we have just under £600m, so just under 10% of the portfolio, in what can broadly be called alternatives. This program was only initiated 2-3 years ago and so it is still in build mode and monies are not just fully invested. We don't have a formal real asset class but we have private debt and absolute return portfolios with opportunistic investments which includes items that are in-between other asset classes. We also have a private equity portfolio where we invest directly into funds.

Royal Mail has a small investment team, so it doesn't have anyone internally to do this, which is why my company advises them on the best of class for ideas and implements these for them. There is no significant ability to do co-investments and the approach is to invest largely via funds because of the small team size.

Hubert: What portion of your fund do you allocate to an international programme of alternatives?

Bev: The fund is is pretty much all international and the investments are currency hedged back to sterling. We look globally and not just for sterling-only assets. Most of the assets in which we invest are in the US and European markets but we also have a significant Asian market tilt. Although South America and Africa are the areas which are not yet represented, we do have a global focus and there is very little in the portfolio that is UK-only.

Hubert: Anders, what is your current allocation to alternatives and what is the role of alternatives in your portfolios?

Anders Thorendal: Our portfolio is a lot smaller than the other panellists and is around 7bn (SK), which is €800m. Traditionally, we have invested in global and Swedish equity as well as fixed income, with a proportion of 50/50 of 60/40. Three years ago we also introduced alternatives as well as real estate. Presently, we have roughly 10% of the portfolio in alternatives and an additional 5% in real estate.

The reason for introducing alternatives was the financial aspect as they don't correlate that much with equity. The other reason was to find something that was an alternative to fixed income. Also, being a church, we see this as a possibility to invest in some more niche investments or other investments that will support the values of the Church in areas related to climate change and supporting people in developing parts of the world. It is important to stress that all of our investments must contribute to the total portfolio, with expected return – we don't make any purely social investments that don't contribute to the total portfolio.

Hubert: Should asset owners be seeking as diversified a portfolio as possible, or is there a limit? If there is a limit, at what point is the limit reached?

Bev: Effectively what is really important when we are investing is the impact of the fund or asset on the total portfolio. Essentially we are looking for diversification at the total fund or plan level, so what we are doing is judged both in a quantitative and qualitative way. We look to add investments that will serve to diversify the fund. This means that anything above 0.2 correlation to global equity markets or 0.2 to global credit markets won't be of interest to us – diversification is the aim.

We don't want the number of managers with whom we deal to be too high. Contrasting with the old fund of fund approach, that would have 35-55 or upwards of managers, we are seeking to have fewer than 10 in each asset class – ideally 5-7. We don't believe that having too many investments is appropriate, particularly because of the governance costs.

At the moment we have about 23 investments across Alternatives, including private equity, private debt and absolute returns. I am not including real estate in what I do since we don't view this as an alternative asset class. Largely, we feel that 10 funds and managers for each major group of alternatives is the maximum that we would look at in order to maintain strategic partnerships with managers and to keep the governance budget down.

Anders: We are also looking for diversification with our investments. It is important, when it comes to alternatives, to understand what the timeframe and horizon for investments is, how much you are prepared to invest in illiquid assets, as well as the overall risk appetite for the portfolio. You have to have these questions in mind when you look at diversification.

We have roughly 10% now, and are moving to increase this number, but it does depend on what management resources you have within the portfolio.

Antony: We don't have any limits; our portfolio is driven more by opportunity rather than having to apply certain mandates to certain managers. We set up a governance structure for decision-

making processes, on both the company and trustee-side, to allow us to execute due diligence and transactions fairly quickly.

Likewise, we can be agnostic as to whether we are making direct investments or using a fund structure and, often, we will create a fund where we are the single investor, merely because it will improve the tax position on ultimate sale, improving our exit price and so return.

We've looked at a number of ways to build up the portfolio with co-investments, alongside fund commitments, but also we have created a non-discretionary portfolio which is overseen by one of our private equity managers. This allows us to identify small opportunities that perhaps, of themselves, might not be justifiable for a scheme of our size – like the A-rate round funding in venture capital areas – and we can use that portfolio as a way of writing tickets of $10-15m, which may not seem like much, but, if we can find a dozen or so of these ideas all exiting at 10 to 20x multiples, it becomes quite a significant contribution in total.

In both private equity and the hedge fund space, we have often been taking equity stakes in the managers themselves so that, rather than getting a discount on the fees, we are getting special economics both from a pay-off in our own contributions and also from in the broader success of the manager's business through the cycle.

In getting those stakes, quite often, we are able to acquire historic interests in partnership distributions, as well, which is a retrospective access to vintage diversification across the piece. It allows us also to trade the equity through and actually enfranchise the next generation of partners because, with all of these illiquid investments, where there isn't an immediate exit route, if things are going badly you have got to make sure that someone is actively managing the portfolio, not just at the point of acquisition and through the early years, but also through the harvesting and exiting stage; that could be the people who are the senior associates and junior partners now, who you still want to have embedded and fully engaged in the firm in 10 years' time. We have often found that it is a good way of giving equity to these guys and keeping them involved in the deal right through to the ultimate exit.

Hubert: What is the upper end of the deal sizes in which you participate?

Antony: We are currently looking at something that would require half a billion pounds commitment, so it is very much driven by the opportunity and pay-off profile. Although I would note that, if you looked at our portfolio, gearing isn't something that features much in it. We have to justify the underlying investment opportunity and not see it as something that is highly structured.

Despite the stuff that we do which, for some, might seem fairly innovative the thesis is generally quite simple and each one can be described in the proverbial two-minute elevator pitch.

Hubert: Should institutional investors be allocating directly to particular managers or does the unknown nature of asset classes such as timber, African private equity, etc. mean a fund of funds approach is nearly always required?

Anders: This also depends on the size of the portfolio, the resources that you have in-house and how much you are willing to spend. Having a small portfolio does limit our opportunities and how much time we spend on each investment.

We are still on a learning curve since, with our resources, we start with small individual managers and perhaps minor investments, in order to try and understand the nature of the investment – and this is the way for us to slowly build up our knowledge in the portfolio. The trend is always to invest with a fund of funds but it is always more difficult for the smaller investor to make that worthwhile and economical. Our strategy is to go slowly, build up the portfolio, and build up our knowledge with different asset managers.

Hubert: What is your process for investing and selecting managers? Do you use a formal fiduciary rating system?

Anders: Our portfolio is very much driven by the values of the Church and everything we do has to be sustainable. We want to find managers that share our values when it comes to investment – and that is both for equity and alternatives. We usually start from this perspective, using a traditional search, but usually it is down to their approach on a case-by-case basis.

We don't normally do a large search but rather build from our network, which may be a little unconventional but so far has worked out very well since we have been able to find managers who have values similar to ours and contribute well financially.

Hubert: Should institutional investors be allocating directly to particular managers or does the unknown nature of asset classes such as timber, African private equity, etc. mean a fund of funds approach is nearly always required?

Antony: It depends where you are looking at in Africa; although we have taken some opportunities in certain countries, we see such a broad story for that continent that it is very much a question of seeing all boats rising on the tide. We are trying to take a diverse approach, capturing as many opportunities, as we can. If we find a good opportunity and partner, and we feel that we have a program that works, then we go with it.

If you look at the US cyber security and tech wave, that is probably a market that will have multiple managers with multiple funds but nobody is quite sure

what is going to be the winner in that market – and you've got competing technologies that you are backing at any one time.

We don't have one single strategy across our portfolio, by asset class or geography, so you have to look at it as fit for underlying investment thesis but it is also driven by our own internal resources and capabilities to conduct due diligence. We don't have a large in-house team at all but we have got a lot of individual advisors with whom we work on the idea of generation.

We often get our asset managers to peer review other asset managers' ideas. One of the problems with not having a large in-house team is that we don't have an equity guy talking to a real estate guy; so we have actively encouraged our asset managers to talk to each other. What we don't want is someone saying they have a better idea than someone else; they know that the idea that is on the table is the one that we want, it's just about how they make it a better idea.

The other layer is trying to work out what is the requisite skill-set that we need for our due diligence and consultancy. Very rarely are we going to find it within the traditional actuarial, banking or consultancy firms; often we will bring on board specific industry specialists to give us a view on the acquisition or post-acquisition stage. This can help to inform our judgement, particularly when we are looking for ideas on what is lacking in a current opportunity that could be made better and in finding embedded value that isn't yet reflected in the price.

Hubert: Do you ever go direct into a transaction, and how does your co-investing with other pension schemes work?

Antony: We are in a fortunate position because we have a reputation for doing deals and having execution certainty. We are regularly approached by other pension funds, asset managers, or direct investors and entrepreneurs who are looking for capital and, because we have a transactional approach, we are more than comfortable acting as the lead fund on a transaction.

We also have a lot of risk and price discipline and can be quite objective, to the point of sceptical, towards the opportunities presented to us. There have been deals such as the Co-op's farm portfolio, where we have walked away since it is no longer seen as good value because you end up paying away all of your future profit to the vendor.

We have always been very open and are happy for others to bring us the idea and, although it might not be the first idea that we leap at, the next one just might be the one that sparks our interest and we will be the perfect partner for it. Particularly if it isn't one that naturally fits with our existing strategy or client base.

Hubert: Bev, what are your thoughts?

Bev: Because we haven't got a large in-house team to analyse specific deals or transactions, we are going directly into funds. We don't think that we need to have large numbers of funds in the same space, which means that we don't feel the need to have a geographic fund in every type of strategy. Instead we try to identify, opportunistically, the best area for investment. We develop institutional relationships with managers that bring us ideas. We do have legacy fund of fund investments. But with new monies we are going into funds, but not at the deal level.

We have started to look at some co-investments. But, in my experience, these are a way to concentrate your portfolio. For managers it allows them to look at bigger deals than they perhaps would have done with their fund size. It is not clear that the adjusted returns on concentration actually pay off that well. Hence, we are very sceptical of just doing co-investment which many others seem more willing to do.

Operational due diligence is of vital importance to us and we use several firms for this. Even though it's easy to get very excited in the initial investment idea it is critical that we actually perform due diligence to a certain standard across both investment and operational areas. In the past we have walked away from certain asset classes, after initially getting very excited about the investment, just because the operational due diligence and the legal, taxation, and investor protection have not come up to scratch.

Hubert: If your fund is very detail-orientated on thorough due diligence, what is your view on outsourcing these areas versus having a small in-house team?

Bev: Yes, we outsource the due diligence and we have a number of companies for the due diligence process and reports. We also have a number of advisors that bring us ideas and we are open to speaking with many managers. The due diligence work is quite significant and can take many months from looking at ideas to resolving all diligence areas. There is a lot of upfront due diligence which is done before investing. After that it becomes more about the ongoing relationship with the manager once we are in a fund.

"Even though it's easy to get very excited in the initial investment idea it is critical that we actually perform due diligence to a certain standard across both investment and operational areas."

Hubert: What esoteric or alternative assets is each of the panel considering or keeping a close eye on and why?

Antony: We are seeing a lot more opportunities coming out of Africa. In particular, we just bought a portfolio of telecoms masts in Nigeria – Nigeria is the 7th biggest user of mobiles in the world. Uganda also looks to be an interesting play; it is landlocked and doesn't have natural agriculture, so grain looks like an attractive opportunity as the emerging middle classes grow and bread becomes important – we have an interest in a port in Kenya that could provide the supply. We are also looking at cattle farming in Australia employing a holistic grazing technique to enhance yields by 50% in drought conditions and supply the increasing demand for beef in China and India.

It will continue to be a broad and diverse portfolio and one side-theme which has been fairly constant through the past 18 months has been cyber security and other technology plays in the capital space. We have a 5% stake in Silent Circle, the only encrypted voice and text communications supplier and manufacturer of the BlackPhone which will probably become the ubiquitous hard and software for the financial services industry in the way that Blackberry once was.

Looking at healthcare, obsolescence and reputation risk are so enormous that the returns don't justify it. The bank itself has had its fingers burnt in this space quite a lot and infrastructure play is not something that appeals to us as something that is sustainable. That isn't to say that there aren't certain technologies that have medical application potential – we have invested in a number of light technologies which have various uses, such as industrial farming, medical marijuana, and farming in the US where we have developed a square light technology which is far more efficient than the standard technology. This has played into other parts with interest being shown from L'Oreal and other cosmetic benefactors that it could be used as some sort of treatment in that area.

We have invested in North Africa where the emerging middle class is indulging in private education, so there are some interesting opportunities there. Clearly, in the digital space, there are multiple opportunities for educating people and indeed, in the microfinance world, you are looking at the 2 billion most impoverished and illiterate part of the world population; but interestingly, those have been the people who are the fastest adopters of digital strategies for their day-to-day lives. You realise that this is how you not only access this market but that there are many ways of developing low-cost contribution models where you have a ready and underserved population.

Hubert: Bev, what are your thoughts?

Bev: For us it is more about diversification. Since we already have an overweight exposure to the Asian markets, we feel confident that this will continue to offer us this diversification from Europe and the US markets. Africa is an area that we are looking at and we are trying to figure out the right way to approach it, because it is such a vast continent that you need to get very detailed and specialised very early.

EM infrastructure, which will incorporate China, India and Korea, is an interesting area; we have an investment in the fund already and are looking into obtaining more. We are looking at ways of accessing the Chinese consumer and the best way to harness growth as the Chinese economy becomes more consumer-focused. Unlike Antony, we do like healthcare. We have an investment in this space in both the US and China; but not in venture capital. We like this theme, not necessarily in developed markets, but in some of the faster-growing markets.

Agriculture is something that we have looked at several times but have not found interesting investment ideas even though it plays to a great theme. We don't necessarily work from a top-down perspective although I can see the appeal.

Anders: We are constantly looking for new opportunities as we are building up our portfolio. Infrastructure is something that we are looking into; also, we are looking into impact investments and microfinancing, etc. There are opportunities and we will see where these ideas lead, but we don't invest without the investments working within our financial requirements for the portfolio.

Hubert: Thank you all for sharing your thoughts on this subject.

2.2 INTERVIEW

Manager diversification and appropriate ways to access to alternatives: fund of funds, partnership structures, advisory approach or via Diversified Growth Funds

Interviewer

Noel Hillmann
Managing Director, Clear Path Analysis

Interviewee

Alan Pickering
Chairman, BESTrustees

Noel Hillmann: Given the pressures you face in evaluating managers, from a trustee perspective, what is the right balance of alternative investment managers, considering the diversification of investments in the scheme and the need to avoid excessive manager risk?

Alan Pickering: In the context of a Defined Benefit (DB) scheme it will begin with a dialogue with the scheme actuary and investment consultant. As a trustee I always try to ensure that both are joined up even though the advice may be coming from different firms.

Having had a dialogue we will then determine the sort of returns that we need to achieve our objectives and will discuss the range of asset classes that might be brought into the mix. I would expect the investment consultant to put before the trustee the range of asset classes that they feel are appropriate to help that particular scheme achieve its objectives. They will then determine how far short of self-sufficiency or buyout they are, and have due regard to the size of the scheme, because you are always going to be allocating small proportions of your total assets to some of these classes.

In a small scheme, if you push the boundary too far and double your money at the margin it hasn't really touched the sides in helping you achieve your objectives.

We would have a discussion with the investment consultant to determine the range of assets that we should be considering. We would then have a teaching for the trustees to ensure that all of the trustees were comfortable with the asset classes - their strengths and weaknesses - as well as what could go right and wrong not understanding every dot and comma. Only after having had that discussion would we think about the range of investment managers that might be considered.

In some schemes we would want a single asset manager to deal with multiple asset allocations and would have to try and find a manager that had the right skill-sets in each subset – not necessarily best in class but certainly someone who had the competence to do it.

In other schemes we could parcel the money out to specialists in each asset class, although the danger in this is that it increases governance burden and would require quite rigorous pruning of those subset asset managers with narrow ranges, as and when that particular asset class no longer fits the bill. If you have an asset manager who can move around between different asset classes you can stick with them for longer than might be the case if it was a purely specialist boutique that only did one thing, representing a tiny percentage of your assets.

Noel: If trustees don't understand various asset classes inside out, how do you guard against excessive manager risk and ensure that the way in which these managers are investing and in what areas they are investing are substantially different?

Alan: Size does matter. If you are dealing with a relatively small scheme then your only option is to buy an off-the-peg package and it well may be a package that has a number of 'alternative' assets within it. As you go up the size scale you do have the option of having a multi-asset manager arrangement or different managers dealing with specific issues.

Again, we would rely on the skill of the investment consultant to bring forward managers, or indeed a manager, who they felt had a track record in this space, had the right personnel to deliver a return and had a product that looked to have a fairly long shelf life. If all of these boxes can't be ticked we would have to have a discussion with the investment consultant about how easy it would be to withdraw money from these managers, how liquid the asset classes are and how frequently the funds are dealt, so that if we needed to get out we would be able to do so in a manner that didn't lose us money or leave us in an asset class with which we were uncomfortable.

What you have to bear in mind is that the asset manager may continue to do a really good job at managing that particular asset class but, as time goes by, that asset class may not have a role to play in our manager line-up given the evolution of our scheme which, if it is a DB scheme, will be on a route to self-sufficiency and possibly buyout. When you get to buyout, you want to have a range of assets that reflect the asset classes of the insurers that are taking the liabilities off your hands; you want to replicate the insurance company's asset allocation to make sure that you can transfer the liability smoothly as well as, hopefully, gain some economies by transferring the assets in specie.

In this brave new world you often have to dismiss a manager, even though that manager is still performing well, because they just aren't doing the job that you need doing anymore.

Noel: How many different alternative assets in one portfolio are too much and how wide and diversified are you comfortable with the fund being?

Alan: I believe that if it is legal, it is investable; but in terms of new asset classes I have to try and make sure that there is some durability and the prominence given to an asset class isn't simply driven by the asset manager's marketing department. Sometimes the asset classes that they push can be so narrow that it fails the durability test.

Noel: Is there a natural desire to fully outsource your alternative allocations to fund of funds or, in your view, do partnership structures or allocations to Diversified Growth Funds (DGFs) offer a better fees-versus-returns opportunity?

Alan: Delegation is at the heart of trusteeship and trustees continually have to decide what to delegate and who to delegate it to. We are almost spoilt with choice in the level of delegation options in the investment world today and the relative merits of those options will vary. There will be some instances where people will want to outsource management of certain asset classes to an intermediary who can then move the money around quickly. There will be other instances where you will want to have three or four directly hired asset managers to cover the asset classes in different ways and configurations.

There will be other instances when DGFs will fit the bill, but trustees need to realise that these are a marketing strapline and you actually have to look at the ingredients on the tin and the make-up of these DGFs, and their use of different asset classes will vary.

This is where we need to make the point of Defined Contribution (DC); increasingly these arrangements are top of the agenda for trustees since this is where the new money is going and where trusteeship can make a real difference. I am a big fan of having a default fund in the growth phases of DC life cycle. Particularly given the tax changes which limit the level of contributions that high net worth individuals can pay into such schemes, we need a DGF through the growth stages and accumulation phase which can have a number of asset classes within it.

I would like them to be white-labelled so that the trustees can add and remove particular components from the mix. I am not a big fan, as far as DC is concerned, of offering members long lists of narrowly focused funds because I can't manage that breadth of opportunities for a diverse membership since I don't know whether they are subscribing to an alternative asset fund because they think it will shoot out the lights or because they feel that it has some ethical component.

In the DC world, if people want to have exposure to alternative assets on an asset class basis we provide them with opportunities to transfer out their assets on a yearly basis; I can then concentrate on the main default fund, allowing those who want access to specialist funds to do so on a self-select basis, outside the trust rather than within it. It is important that we don't become DB-centric as it is increasingly a legacy, whereas the new money is going into DC arrangements.

Noel: For those funds you've worked with as a trustee, does co-investing provide the best synergies for exploiting long-dated illiquid investments like infrastructure, private equity and real estate?

Alan: I am old enough to remember when it was quite usual to have common investment funds, often within the context of a large conglomerate that might have different pension arrangements for different group of workers but might want to pool the assets. Nothing is new in the world of pensions – what goes around comes around.

In one of my schemes we did have access to an infrastructure fund where we were investing alongside folk from a similar background since the asset manager brought together the partners rather than the partners finding each other. This particular product was created in the pre-2008 environment and didn't have a good financial crisis plan; so, in that particular context, the trustees are wary of those sorts of arrangements with, allegedly, partners that have synergies and fixed get-out dates.

It is not necessarily a good experience having lived through the financial crisis, but we do have a lot to learn from the large Canadian pension schemes that do seem to be able to bring together alliances in order to co-invest in long term and potentially illiquid arrangements.

In the UK a number of the local authorities are now getting together to see if they can leverage their involvement in this sector. We have seen what was the National Association of Pension Funds (NAPF) and is now the Pensions and Lifetime Savings Association trying to bring together folk of a like mind to fish in this particular pool. As long as we can bring together people who have similar risk tolerances and timescales, I can see a lot of positives in these sorts of collaborative arrangements where one can pool ones assets into these markets.

Noel: Thank you for sharing your thoughts on this topic.

SECTION 3

LIQUID ALTERNATIVES

3.1 WHITE PAPER

Liquid alternatives – ready, willing and (in select cases) very able

3.2 INTERVIEW

Accessing illiquid investments as alternatives

3.1 WHITE PAPER

Liquid alternatives – ready, willing and (in select cases) very able

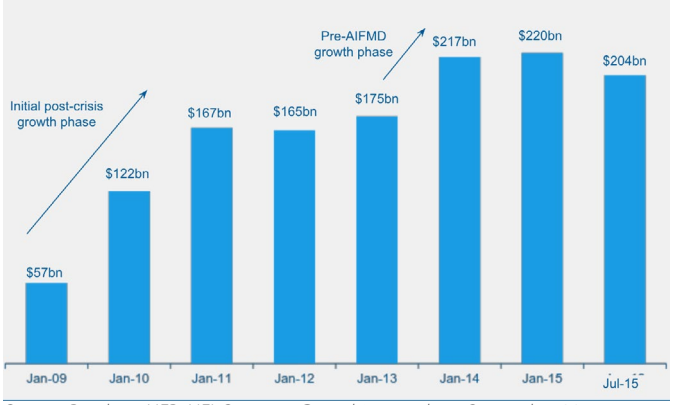
Vicky Hudson
Senior Investment Manager, Aberdeen Asset Management

A great deal has changed in the world of investing over the last 10 years – not least the broad acceptance that alternative investments are not an optional extra in a well-diversified investment portfolio. Yet for many investors – from individuals with Investment Savinds Accounts (ISAs) or Defined Contribution schemes, to institutions requiring products with higher levels of regulatory oversight – high quality alternative investments have often been hard to reach. To address this gap, liquid alternatives have arisen. Given the quality of options available, the diversification that they can bring, and the market environment we find ourselves in, now is a great time for investors to fully explore their potential.

The emergence of liquid alternatives

We've seen significant growth in the liquid alternatives universe over last seven years, as illustrated in **Chart 1**. There are two core elements to a liquid alternative fund – their regulatory status and their underlying investment approach. In essence they can be defined as "diversifying alpha strategies, wrapped in a regulated, easily-accessible structure". In Europe they come within a Undertakings for Collective Investments in Transferable Securities (UCITs) wrapper (in the US they are alternative mutual funds under the terms of the '1940 Securities Act' – often known as '40 Act' funds).

Chart 1 - Growth of UCITS AUM in the hedge fund industry, 2009 – 2015 H1



Source: Barclays, HFR, HFI, Strategic Consulting analysis, September 2015

The interest in liquid alternatives jumped significantly after the Global Financial Crisis, as liquidity and regulatory comfort were at the forefront of investors' minds. While early funds were largely long-biased strategies, the growth in investor demand has encouraged the development of more alpha-driven and more diversifying investment strategies. In many respects these strategies are not new; they can claim heritage from the hedge fund industry. While there has been much for people to grumble about with hedge funds, they have certainly led the way in their efforts to find the best sources of investment alpha. Hedge funds have started to bring their experience to the liquid alternatives space – both directly, with their own fund launches, and indirectly, as their experience and insight has spread through to traditional asset managers.

Understanding alpha

With the help of the academic community, the understanding of hedge fund alpha – and the repeatability of the returns that can be generated without reliance on the equity markets – has increased markedly over recent years. Alpha has often been thought of as intangible "manager skill", but often it comes from experience, expertise and opportunity as much as innate investor insight. Managers unconstrained by benchmarks, able to invest in instruments avoided by typical long-only funds, and with experience in using derivatives and, occasionally, leverage, have been able to capture opportunities that traditional investment funds are unable to access.

Within a liquid alternative format, we believe that some of the most attractive alpha strategies can be found within global macro, relative value and long/short equity strategies. These strategies work well within the liquid alternatives wrapper because they are implemented using liquid and plain vanilla instruments – equities and bonds, exchange traded futures and other liquid derivatives. For example, global macro strategies use futures and forwards to take long and short positions across asset classes in order to benefit from global trends and country specific market dynamics. With diverging monetary policy across the world, an evolving Chinese economy and a period of global political change – including new parties emerging in Western Europe through to the continued repercussions of the Arab Spring – there are numerous reasons to expect increased market dispersion. Over the last few years, Quantitative Easing (QE) has served to dampen much of this volatility - enabling risk assets, such as equity, to rise steadily. As the impact of QE wears off – and countries such as the U.S. move to a period of rate rising – macro managers should find increasing opportunities to generate alpha.

Importantly, from an investor perspective, these strategies are also some of the most diversifying sources of alpha. Because they are not reliant on the long-term performance of the equity markets to drive their returns – indeed relative value strategies typically have no equity market exposure at all

– they have historically been lowly correlated to traditional equity investments. The average global macro manager generated good positive returns through 2008[1].

So liquid alternatives are a no-brainer?

Well – yes and no. Yes insomuch that they offer a way for many investors to access alpha that would otherwise be out of reach. Yes also that they offer a framework that is conducive to the active management of a range of compelling alpha strategies. The caveat is around the particular fund (or funds) you allocate to. By definition liquid alternative funds are trying to generate you alpha. While we can understand the drivers of that alpha, it is important to note both that some managers are better at capturing it than others and also that each type of alpha – as with any source of investment returns – is likely to be cyclical with down periods as well as up ones. The implications are that manager selection and manager diversification are key elements to a successful liquid alternatives allocation.

In terms of manager selection, we believe that the same rigour is required in terms of investment and operational due diligence as for investments in offshore hedge funds. The UCITS banner in particular does not provide any stamp of quality as to a manager's investment skill or experience. In many ways the lower barrier to entry has made it easier for mediocre investment managers to launch products in the space. Moreover the universe itself remains distorted with many equity driven strategies that offer little in the way of a really alternative source of returns. To be able to offer the highest conviction ideas to our clients, we have had to create customised accounts with managers rather than invest in off-the-shelf UCITS funds.

Even with good manager selection, we also believe that it is important to access the space in a diversified way. Alpha is not a homogenous source of returns – different alphas work well in different market environments. By blending managers (and therefore alphas) we can create a more reliable and less volatile source of growth that provides better diversification within a traditional multi-asset portfolio. It has always been a source of frustration to see an investor walk away from truly diversifying alpha because they tried to access it without the benefits of manager diversification; their view clouded by over exposure to a style of management that is out of favour or through poor manager selection.

Indeed, the need for good diversification is particularly important today. Equity markets have had a strong run and have started to become more volatile. Although it is not uncommon to see equities falling more than 10% during the year, the summer turbulence is a recent reminder of the potential risks of investing in equities alone. More notably, however, it seems hard to imagine Gilts providing the level of protection – and indeed returns – investors have been able to benefit from over recent years. We believe that it is therefore a particularly important time to access the true diversification that can be found from a portfolio of alpha strategies – both to enable investors to continue to grow their assets over the long-term and also to reduce volatility and drawdowns on the route to that growth.

Conclusion:

Overall we believe that liquid alternatives can – and should – form a core part of an investor's growth portfolio, providing strong diversification within a traditional multi-asset portfolio. Regulated and often daily dealing, these new strategies provide access to alpha that has otherwise been out of reach for many investors. While there is no shortcut to manager selection – and the importance of manager diversification might create a governance challenge – ultimately liquid alternatives can provide a differentiated source of returns to help meet investors' long-term growth requirements as well as reduce the impact of equity volatility on their returns.

1. *For example the HFRX Macro/CTA Index returned 5.6% in 2008.*

3.2 INTERVIEW

Accessing illiquid investments as alternatives

Interviewer

Noel Hillmann
Managing Director, Clear Path Analysis

Interviewee

Mark Hedges
Chief Investment Officer, Nationwide Pension Fund

Noel Hillmann: What type of illiquid assets do you currently invest into and what is the primary role of illiquid assets in your portfolio, i.e. growth driver, de-correlated returning asset etc.?

Mark Hedges: Primarily, the bulk of our illiquid assets are about generating return which means generating alternative returns to equity. We split our portfolio into return-seeking assets and matching assets, with these matching the liabilities as best we can. We do have some alternative assets in that matching bucket, which we hold as margin pick-up; but we hold them because they have RPI-linkage and so good inflation hedging that acts as an alternative to your classic gilts and linkers for hedging the liabilities. These are long lease properties and ground rents.

Our portfolio is slowly building up but is still relatively small at the moment, at around 2.5% of the fund, although we are looking to build that up to 10% of the fund. The bulk of the illiquid assets are return-seeking assets and we have a target to reach 20% of our assets in illiquid return-seeking opportunities. At present we look at real estate, infrastructure, classic private equity, real estate debt, and private debt funds within that allocation.

At the moment we sit at around 15% of assets, perhaps slightly more, so we do have a little way further to go. These funds will distribute as they start to mature and have to be replaced; so it isn't a steady state sort of position since most of these structures are closed-ended GP/LP structures.

More recently we have entered into an open-ended infrastructure fund, shifting the dynamic slightly in our return-seeking portfolio. Most of it is primarily based on capital growth strategies, although more recently we have looked at income generative ones. We would see this open-ended infrastructure fund as being more income generative.

Similarly, the debt funds that we have entered into are more income focused, as opposed to capital appreciation, but the bulk of the illiquid allocation is focused on what we would call capital appreciation activities – things like classic 'buy and build' private equity, where you invest in a fund and it buys into small or medium enterprises i.e. family-owned or entrepreneur established that need to be professionalised or institutionalised so they can grow cash flows and move from being a regional firm to a national or international company. This strategy is very much based on buy and build and then selling the company on at a multiple of its purchase price.

Opportunistic real estate is much the same and we would see it as capital appreciation because you are investing in property that has been under-managed, under-let and needs to be refurbished and re-let, so that it can then be sold on as a core property 4-5 years later.

Our primary strategy, given where the fund is at the moment is more around these capital appreciation strategies; but, over time we would perhaps see a shift towards some more income generative strategies. The balance is 80/20 at the moment but might move towards 50/50 as the fund starts to de-risk and we look more towards income to meet liabilities. This would be a way of doing that in tandem with the matching asset strategies.

At present it is more about trying to close the gap in the deficit and clawing back some of the shortfall in the fund overall.

Noel: What approach have you taken to investment vehicles? Have you gone directly down a segregated account co-investing with other funds?

Mark: For our alternative matching assets – the ground rents and long lease property – we have two segregated mandates that are specific to us. We also have one fund investment as well in long lease property so we are following both strategies there. Our illiquid return-seeking activity is all pooled GP/LP structures, so the classic private equity fund manager structure. We aren't big enough to create a separate account given that we want diversity in the activities and we tend to be quite opportunistic.

We don't set an allocation to real estate, private equity or infrastructure since it is more a question of where we feel the market is offering the best opportunities at any particular time. We might invest in three or four buy and build private equity firms in a year and the following few years not do any because we felt that we had targeted it at the right time.

It is pooled fund General Partnership (GP)/Limited Partnership (LP) structures

for the bulk of these activities because we are typically doing clip sizes in a fund of £30-50m and, by and large, that is not big enough to do a segregate mandate. It also becomes difficult since, unless you are a big player like the Canadian or Dutch pension funds, it becomes very difficult to say 'here is a big pool of money; we want this to be done because we aren't able to invest enough.' So it does have to be fund structures on a pooled basis.

We haven't done any co-investment but we are looking at whether or not, within those investment activities, we can do it. Our position is still a little undecided since we can see that there are benefits in fee structures and you can get better return because you are not paying the same management fees; but the downside is that, typically, a fund may only have two or three investments that are available for co-investment. This tends to make things more concentrated, giving rise to the concern as to whether you are getting investment in the best quality or the lower quality ones within that fund. Typically they may have 10-12 positions and, if they are only doing three co-investments, your exposure is a bit more specific and less diversified.

It is something that we haven't made a final decision on and we are writing a final paper for our investment committee coming up in December; so it is an area that we want to look at but, at the moment, we haven't done it.

Noel: What additional returns do you expect from having an illiquidity premium?

Mark: It depends on the assets since you obviously get different returns from different assets. If you look at some of the debt structures, which fell anywhere between 3-7% pick up against more liquid investment-grade fixed-rate deals, you are obviously going down in credit quality. Small enterprises in the private debt space aren't going to be triple-B rated. They are going to be in the single-B rating, so what you are getting is a combination of illiquidity and credit pick-up in terms of your yield; but you are taking on two additional risks, one being illiquidity since you can't trade it well, and the other is the fact that you are taking on more credit risk compared to what you might normally.

"It has always been a view of mine that secured lending looks more attractive than high yield"

We could look to high yield but, in general terms, high-yield bonds are unsecured. Private debt markets are secured debt and typically have a better loss recovery and default rate than high yield and typically you get some margin pick-up and maybe 1-2% against high yield in comparable credits. It has always been a view of mine that secured lending looks more attractive than high yield which tends to be more liquid and more volatile.

In the private equity space you are looking for somewhere in the region of 1.5 to 2x multiples on your capital and maybe 15-20% Internal Rate of Return (IRRs); so, you are looking for fairly substantial pick-up against your public equity investments where you are looking for about 7%, depending on whether you are passive or active..

We see quite a range, although I guess that core property is probably not going to generate a return in excess of equities; but, you could argue that it is secure as it is, more stable and gives you longer-term cash flows that mean you are prepared to take a slightly lower return than public equities.

You do have to be wary of infrastructure as it has an equity position so it can be quite challenging at times. There have been a number of issues with infrastructure equity which suggests that it isn't as stable or as regular an income stream as you might have expected. There are a number of risks to it but, overall, if you can hold it for the long-term you can probably get 6-8% returns, probably less risk than public equities again, although that isn't to say that it is without risk as it can be quite volatile.

It is very much about finding opportunities and, as I mentioned before, we look at the opportunity set. We looked at real estate debt back in 2011 and thought that the European real estate market offered opportunity as people couldn't borrow. There was a good position here in mezzanine debt because whilst senior debt was available it was limited to 50% Loan-to-Value (LTV) at the time. Overall values had dropped so the equity player had to put in more money and we felt, at that point, that there was an opportunity in the mezzanine space to get 12-13% returns because there was a shortage of finance and mezzanine debt that could make the deal happen. We have seen good returns from the fund that did invest in this at that time.

At the moment we aren't focusing that much on new private equity funds because the underlying asset prices look questionable. Now is a good time to be receiving value from your funds since they are exiting at good multiples; but people are paying higher multiples for new businesses, so we are not focused so much on this at the moment and are looking to other niche areas. Returns are comparable or better depending on the risk to public equities. It is certainly better in private equities but it is variable and dependent on where we see the opportunities.

We are looking at one or two shipping funds because we feel that ship costs are at a 20-year low and charter rates are at a 30-year low which suggests that the direction of travel from here is going to be upwards so there may be value there. But it is a quite specific asset class so it may prove difficult for our Trustees to get comfortable with.

Noel: How do you quantify the level of illiquidity premium you're prepared to take on?

Mark: You can eventually transact some of these things in secondary markets but the basic view is that you are locked up for the life of the fund. The way we view it is much more holistically and we try not to quantify each individual investment and really look at how much illiquidity we can have in the pension fund. The pension fund primarily is gilts and equities, both of which are very liquid. If we hit our targets of 20% in illiquid return-seeking assets and 10% in alternative matching assets, all of the rest of it – around 70% of the funds – is in liquid assets which I could effectively liquidate to cash today. I am, therefore, not that concerned with the amount of illiquidity that these funds bring me. When I look at what our forecast cash flows are and I start thinking of the 5-10 year lives on these funds, on average if I were to stop doing the illiquid assets, the peak would be five years out and then it would decline as I get distributions and run off. I wouldn't run into any issues given that I have an income coming in and my fund has a duration of 22 years; so I have a long way from our peak cash flows where I am selling assets to meet liabilities. We take the view that having 30% of the fund in illiquids is unlikely to be a problem in relation to liquidity.

"We take the view that having 30% of the fund in illiquids is unlikely to be a problem in relation to liquidity."

The issue is whether I can quantify, whether I am getting good returns for the illiquidity premium. That is difficult as you are looking to benchmark that against public, tradable assets and these things are different since they can't easily be accessed in the same way because they aren't tradable in the same way. You then have to come up with a proxy, which you can do with infrastructure, and ask whether (if you bought public equities or some similar sort of activity) you would have a better return or lower return from the fund. You might get 1 or 2% pick-up.

Similarly, if you are looking at private debt and comparing it to high yield – which would be the obvious comparison, although it is a different beast – you are probably in a similar sort of space in terms of your credit risk, so you can try and quantify that pick-up for the illiquidity.

With other activities it is difficult to say since you could look at Real Estate Investment Trusts (REITs) as a comparison to property. But, REITs tend to be influenced as much by what is going on in the rest of the public equity markets as they are by the underlying property values; so, I am not convinced that it is a perfect alternative.

Again, if you look at private equity, what is the alternative? With buying, say, public equities, you get all of the mark-to- market volatility; private equity can be volatile in actual returns, but it is not as volatile on a daily basis and doesn't move around in the same way. Also, I am buying into a conviction that the managers we are buying into are going to deliver some real value by taking a business, professionalising it and bringing in expertise that, perhaps, the founder doesn't have with a plan for growth. It is very difficult to come up with a liquidity premium other than you are clearly receiving a premium over and above public equities for the overall package. There is a fundamental risk in private equity that this isn't a big institutional investment, so there is inherently more risk than a FTSE 100 stock.

Noel: How do you ensure that the rational and mathematical decision trumps the emotional desire to have access to your cash?

Mark: It comes back to the holistic view that we take in saying that 70% of the fund is in liquid assets and I can realise a lot of money today in cash. I have 85 years of cash outflows, so how much cash do I really need over the next five years? So long as I have a big enough buffer from the liquid assets, why would I get concerned? The trustees also have this view. Pension fund management is a long-term business for most funds. Even though we are closed we still have 22 years duration, so our peak cash flows are quite a way out and we are not selling assets at this point to meet liabilities.

If you are a pension fund, that is in a different situation. Where it the fund is has to sell assets in order to meet cash flow, clearly, liquidity is a much stronger driver. It becomes a quite specific question for each individual pension fund; but there is a fairly predictable liability profile that enables it to consider how much cash and liquidity it needs.

One of the risks at the moment is clearly whether we going to see more people taking out of their pensions, because they have the freedom to take some of that money out which they didn't have in the past. This might start to impact our cash flow needs and it is something that we need to be aware of; but not everyone is going to start taking their pension pot away when they retire.

Maintaining 70% of our assets in a liquid format gives us fairly good certainty that we are going to be able to meet our liabilities when they fall due.

Noel: What emerging illiquid assets are you keeping a watchful eye over, and for what reason?

Mark: One of the things we are looking at is shipping funds which is slightly different and might be challenging for the trustees; but to me there seems to be value there since costs are at all-time lows, as are charter rates. Generally speaking, markets at lows

ought to pick up so there should be some value there. It is generally a good idea to buy when things are cheap rather than when they are expensive.

We are also looking at one or two niche activities in the credit space where there are fewer players and *the* banks have dried up their finance. However, they may be more specialised and complex so *they* offer a bit more premium and probably are less likely to attract new investors because they do look more complex. These are asset-backed activities such as leasing etc.

The question for these is finding the right managers to do this sort of activity since they have to have expertise and a track record; but, we do feel that potentially there are some opportunities there because people will be less likely to be attracted to them because they appear more complex and niche. They can be, however, steady and regular markets to the people that understand them. A lot of the more mainstream activity looks to be generally overpriced just like much of the public markets.

Noel: Thank you for sharing your thoughts on this subject.

"A lot of the more mainstream activity looks to be generally overpriced just like much of the public markets."

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