INVESTING IN ALTERNATIVES, EUROPE

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Exploring the drivers behind investors' increasing appetite for investing in alternative asset classes.

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Investing in Alternatives, Europe

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SECTION 1

THE RATIONALE FOR ALTERNATIVE ASSET ALLOCATION

ROUNDTABLE

Assessing the value of investing in alternative assets over the long-term and what drives good performance

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Andrew McCaffery
Global Head of Alternatives, Aberdeen Asset Management

Margie Lindsay: How do you define alternatives? How do you put them within a portfolio?

Bev Durston: I am an adviser for the Royal Mail Pension Scheme as well as other institutional investors, and I have found that they all have different approaches as they have unique organisation structures. Some will keep alternative assets together whilst others, depending on size and sophistication, will manage them amongst other asset classes.

Alternative assets can be return enhancers, risk reducers, diversifiers, or a combination of this. You need to get the overall framework right and understand what you want alternative assets to do within your portfolio.

Equity-like alternatives, such as private equity, fit into an equity bucket rather than an alternative bucket. And for some investors, property also fits into an alternative bucket. This then leaves a range of alternatives that are diversifiers within a portfolio. It could be a variety of strategies and sub-asset classes, but they are generally devised to offer an alternative to credit and equity beta.

Andrew McCaffery: The term "alternative" is a bit of a misnomer today, derived from being an "alternative" to equity and bond market exposure; it has become a catch-all for so many things in people's minds. At Aberdeen we break it down into different categories of investment style and liquidity, covering liquid alternative strategies, private markets and real assets. This is driven by our desire to cover all areas of potential investment. We like "liquid alternatives" - primarily the hedge fund-like strategies and those that you are able to access in a relatively liquid form, "private markets" - covering all forms of private debt and equity investments, and "real assets"- which includes infrastructure and property.

I would agree with Bev in that for some investors, the difficulty with allocating to alternatives is where they sit, i.e. which 'bucket', the degree of understanding required, expertise and monitoring resource, as well as the overall analysis that takes place. For example, it will require very different expertise and analysis if you are getting into direct lending for small- to medium-sized enterprises than if you have a high yield bond fund.

Real assets are another way to access longer-term real income or growth exposure, and can give investors the opportunity to participate in a combination of potential economic growth, and the potential for enhanced income. In this area, we would look to infrastructure and other areas where we would straddle types of private equity exposure, property and agriculture or timber.

We use these 3 broad categories (liquid alternatives, private markets, and real assets) as a way of achieving certain characteristics and qualities within a portfolio and to meet key objectives an investor is seeking.

Anthony Kleinheerenbrink: We have allocations to private equity and hedge funds in our alternatives category. In the past we have also had allocations to commodities in this. Similarly to many other pension funds in The Netherlands, we consider real estate as a separate asset class.

Ulrik Dan Weuder: We do not consider real estate or private equity as alternatives. However, we include the investments such as infrastructure, natural resources, energy, and special situations as "alternatives" even though they were around long before listed markets. We don't specifically call it "alternatives", but that is broadly what we categorise as alternatives.

We invest into real estate and private equity through subsidiaries, which is done based on mandate. The rest is done from ATP's headquarters where each investment is mapped up against a characteristic that the investment has and then fit it into our

general portfolio, depending on what characteristic that investment has, be it inflation, liability hedging, equity or credit play.

Margie: What proportion of a well-diversified portfolio should alternative assets contribute?

Bev: Looking at institutions around the world, there are different experiences that depend upon whether or not they have specific liabilities or income requirements to meet. The typical endowments such as Yale, Harvard, etc. would have very large proportions in alternative assets of around 50-65%. Whereas pension funds, in the UK for example, generally have a much lower allocation to alternatives which is in the region of 5-25%. Sovereign wealth funds, on the other hand, will typically allocate a quarter to a third of the portfolio to alternative assets. So it very much depends on the type of institution and whether or not that institution has specific liabilities to meet, what the objectives are, and whether or not they have income requirements to meet.

The alternatives industry is clearly becoming less "alternative" as more people are investing into it because of the diversifying effect of these assets. This is particularly at the end of a long liquidity bubble when a lot of listed assets are very keenly priced.

Defined contribution (DC) plans, particularly in Australia and the U.S, have generally had very little in alternatives but they too are now also developing the liquid alternative idea and starting to go down the path of adding them in.

Andrew: There are a number of considerations. One theme that has been around for 15 years, i.e. post the technology 'boom and bust', is the concept of achieving traditional asset diversification. Sadly, this is sometimes misunderstood due to a number of the alternative assets not being diversifiers from a risk factor perspective. They may appear to have different return streams, but the underlying drivers for their returns can be very similar, such as the point of private equity into an equity bucket, or private debt into the credit or bond bucket. They are often wrapped up as a 'diversifier' when there are actually more specific diversifying strategies to bond and equity exposures. These types of alternative exposures should provide, and have provided, diversification if you have a medium- to longer term horizon.

> " investors are seeking return or income enhancement, hence the increase in infrastructure and longer term 'real asset' plays. "

We have noticed investors are seeking return or income enhancement, hence the increase in infrastructure and longer term 'real asset' plays. This is increasing as investors become more comfortable with the concept of an illiquidity premium that can be harvested over time and the value of the 'asymmetric information' in several less liquid investments. We are also noticing that it is tending to draw attention to what a sensible allocation level should be, to meet diversification and income growth needs. This all points to higher allocations for many investors compared with today.

In general, the opportunities and qualities of alternative investments suggest higher, or core, allocation levels into double figures. When considering specific recommendations to investors, we take a very granular look across the universe, be it private markets, hedge fund strategies, or real assets, and think about what the return drivers are and what will give them the 'tailwind' required to add value and outperformance for a client portfolio. However, we also consider what the key 'headwinds' are, and then look at how these compare to the overall portfolio, given the liquidity profile and our expectations.

Anthony: Our starting point within the pension fund is our coverage ratio and from this, we have a certain risk budget. A part of the risk budget is needed to hedge our liabilities. We are now a closed-ended fund so we don't earn any premiums anymore. Therefore, we need to reconsider the interpretation of our investment policy divided in a matching and return portfolio. Alternatives are part of the return portfolio, but we also want to benefit from the diversification and so we feel that the proportion should be at least 5% to have the benefits of diversification. The same applies to real estate, which we consider as a separate asset class.

Ulrik: Every organisation looks at alternatives differently. I think one could say that we are more specific in looking at what fits in the alternatives space as it has to have specific characteristics that we can use in our portfolio. We try to get our exposure through a direct route where we can control and manage the characteristics that these specific assets have.

If you take out private equity and real estate, our allocation currently is somewhere between 4-6%. As it is a one-by-one investment trying to match up with our portfolio construction, it tends to be a pretty complex and long process.

We don't have a specific benchmark of where we try to be, but rather, we try to be opportunistic. We currently think it is a sellers' market and thus, our allocation is less than it has been.

> "You need risk-adjusted rewards for these types of investments."

Margie: How do you measure the impact of these investments on the portfolio in a meaningful way?

Bev: We try to allocate a benchmark for our alternatives and we also try to have secondary and third benchmarks, if at all possible. Thus, we will try to have peer-based benchmarks as a secondary benchmark, or something which represents the universe as a secondary benchmark. You are trying to understand whether or not you have the right strategy, and also a reasonable manager in that strategy. These are quite separate contexts, so you do need to be able to answer both of those questions.

On an absolute return portfolio, we would have a cash plus-type benchmark. But in the current environment, we don't think that cash plus of 2-3% has been a very useful benchmark so we have imposed a minimum hurdle of 5% for our absolute return portfolios. If you think that these managers have very little beta and exposure to market directionality, given that rates are at 0.5% or less around the world, it is quite hard to get 5% with anything other than skill. Therefore, managers should be giving us at least 5% in an absolute return context which is a stretch target.

Private equity in the private equity bucket will be benchmarked according to an internal rate of return (IRR) based listed market benchmark on a like-for-like basis so when you put money in and the manager draws down, you get comparisons with listed markets.

Risk is really important and drawdown analysis is hugely important for us to understand. We would potentially rather give up some returns in order to have our downside protected, and so it is risk-adjusted returns that matter, not just benchmarked returns.

Andrew: Indeed it is important to ascertain what the embedded risks are, so you do need to think in the risk-adjusted return space. Part of our process starts with looking at what are the risk-adjusted return expectations and what are the different liquidity profiles, to determine which areas across the universe of potential investments and opportunities should be considered for particular client objectives.

We also have a number of internally created benchmarks to review the investment universe. If we take something like hedge fund strategies, we break it down into a number of sub-strategies and then compare against those for allocations that are being made. This is so we can see whether the manager selection is in line with our expectations, and do we have the potential to beat what we would expect as an average return from that strategy area. Once you move into the less liquid areas it does become more difficult and we are currently looking at additional data sources to consider effective comparisons and understand any 'premium' we may be accessing. We hope this all feeds back into understanding the portfolio impact in a more meaningful way.

Margie: Anthony and Ulrik, how do you measure the impact of these investments on the portfolio?

Anthony: Our starting point is our investment beliefs. Primarily, the fund is managing the risks of the balance sheet (assets and liabilities). The fund is in control so complexity will be avoided as much as possible; resulting in transparency of investments. Finally, communication about all these aspects needs to be understandable for the stakeholders.

We have an indexation ambition and we want to protect our coverage ratio as much as possible. With this in mind, we performed an asset liability management study and from this we distinguished a matching portfolio and a return portfolio. Within that return portfolio, there should be a place for the types of alternatives like private equity and real estate. For each category, we have defined benchmarks so with private equity we use MSCI World equity benchmark increased with an additional risk premium. Internally, we are also looking at the internal rate of return on a long-term basis and we have some defined benchmarks for property as well.

Ulrik: You need risk-adjusted rewards for these types of investments. We look at the characteristics and risks of the individual assets, as well as the return expectation associated with it. How we monitor this is based on the assumption that we made going into the investment, and how well that individual investment is performing with those assumptions. It is not really relevant to benchmark as each investment is different so you can never find something that is identical. We think that it is more relevant to compare development based on the assumptions going in.

One always get scrutinised on the nominal return that you get out of your investment portfolio although it should be risk adjusted. Otherwise we are comparing apples and oranges. Imagine if we tried to benchmark nominal returns on unlevered onshore wind in assets in Germany with highly geared merchant power generation in Brazil.

Margie: Does the long-term performance of alternative assets overcome the relative illiquidity and/or minimum lock-ups associated with some alternative assets?

Bev: We don't assume an illiquidity premium over all time periods although it is nice when you can harness it. Infrastructure is certainly one place where you are probably not harnessing the illiquidity premium at the moment.

However, we feel that lock-up vehicles have advantages to us in that we don't have to choose the exact time to put the dollars into that strategy as the manager draws down over time. It also eliminates us from market timing mistakes that we might otherwise have made.

Lock-up vehicles also allow managers the freedom to execute their strategies to invest and divest over a period of time, which is actually advantageous to the results and potentially more valuable than the illiquidity premium.

Andrew: There is an illiquidity premium that can be captured and it comes in different forms. Despite the attacks of recent times on many hedge fund managers, if you were to go for longer lock-ups with some of the managers who tend to have slightly longer-term strategies, you would get paid for that as net returns are higher. So the opportunity to be able to marry lock-up of capital to a strategy profile whether it be 3-5 years in this instance, will pay an added return through time.

For the broader private markets illiquidity premium, I would refer back to some excellent research that has been carried out over the last 2 years predominantly on the private equity space by Harris, Kaplan and Jenkinson. This research throws up a number of different aspects that if you can look out to a cycle, which I would classify as 7-10 years, you tended to get paid a reasonable illiquidity premium in the region of 2.5-3%. There are many caveats attached to achieving this or exceeding it consistently, with manager selection being one of the big ones.

For the overall outlook, at the moment it is a sellers' market. We have tended to harvest liquidity rather than take on significant illiquidity recently, mainly because we feel that a number of markets and investments are mispriced and expensive. So to harvest this illiquidity premium over time, you do still have to consider where you are investing in the cycle, and the specific qualities of the opportunity that you are looking at.

Anthony: We differentiate between whether you can earn illiquidity premiums with the performance of the asset, or on the risk side. With real estate for instance, our opinion is that on the longer term, we can't earn an illiquidity premium on the performance compared to listed real estate, but we can earn an illiquidity premium on the risk side resulting in better risk adjusted returns.

Ulrik: At ATP, illiquidity is managed at a portfolio construction level where we decide how much illiquidity ATP wishes to have overall, and how much illiquidity is desired in each risk category. We then use a risk model to find out how much we can actually invest in nominal terms.

When we invest into these assets directly, one of the categories that we split up in terms of where the return comes from is actually the illiquidity premium. So we start from a risk-free point, add the return required for the asset specific risks and on top of that is the illiquidity premium. One also needs to consider timing buying at a good time, or not so good time, as well as what the complexities are that come with this asset, and many other issues. But we always try to map out the so-called illiquidity premium in the direct investments that we do.

Margie: Thank you all for taking the time to share your insights into this topic.

> "Lock-up vehicles also allow managers the freedom to execute their strategies to invest and divest over a period of time. . . "

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SECTION 2

MANAGER SELECTION AND DELEGATION OF INVESTMENT

2.1 INTERVIEW

Factors to consider when selecting the appropriate investment managers and funds for exposure to alternatives

2.2 INTERVIEW

What level of responsibility and choice over assets should a non-professional alternative investor take when allocating to alternatives?

2.1 INTERVIEW

Factors to consider when selecting the appropriate investment managers and funds for exposure to alternatives

Interviewer

Chido Tagarira
Senior Publisher, Clear Path Analysis

Interviewee

Alan Goodman
Senior Portfolio Manager, Pension Protection Fund

Chido Tagarira: What types of alternative assets do you have in your portfolio?

Alan Goodman: The Pension Protection Fund (PPF) has an allocation of 22.5% to alternatives which includes property, private equity, alternative credit strategies, infrastructure, farmland, timberland as well as absolute returns strategies. The subdivision of that 22.5% will vary over time but at the current position we are more highly exposed to some of the alternative credit strategies which take advantage of some of the de-leveraging that has taken place as a result of the global financial crisis. Whereas, our timberland strategies are still relatively new and we are still in the build-up phase so those represent a smaller portion of that allocation.

Chido: What are some of the factors that you have to consider when thinking about adding an alternative asset class to your portfolio?

Alan: With traditional asset class selection, it is normal to seek strategies where an optimal amount of value can be derived in the current environment. One of the more important factors when putting that into the context of alternatives is the liquidity of the underlying investment. Some of the newer credit strategies that are arising out of the changes to the regulations in the banking sector could have a 1 or 2 year investment horizon. Whereas, due to the nature of the timberland strategies, they have longer horizons.

With alternatives, you are looking for diversified return streams and to achieve the optimal blend within those, one has to consider where the opportunities are, and also what the timeframe for value realisation of these opportunities are. For some of these strategies, the impact from the global financial crisis has been heavier which can be optimal to invest in right now, but some of the strategies (e.g. timberland) value accrues over a 10-15 year horizon as they are more driven by medium-term demographic changes around the world.

There are different return drivers going on within each of the underlying strategies, and in comparison to traditional liquid markets it is also harder to work out how you judge illiquidity derived returns from alternatives. You can't just pile in and out of property or private equity, for example, as it takes time to build positions and to accrue returns from them.

Chido: Do you have a number of managers that you are dealing with for each of those asset classes?

Alan: Yes. The PPF uses external investment services, particularly around alternative exposures. We invest in property globally but by its very nature it is a local asset class, so we will have managers in Asia, Europe, America and UK. However, with some of the other strategies like absolute return macro which are a bit more systematic, and diversified macro funds which utilise market driven factors to generate return, diversification is inherent in the fund so we don't need to diversify in the same way as other alternative strategies.

Chido: Do utilise diversified growth, multi-asset, and absolute return funds as a way of gaining exposure to alternatives?

Alan: Yes, we have absolute return funds. We do not have much exposure to multi-asset funds for alternatives exposure as we tend to hire specialist asset managers in different sub-sectors. This can mean that one of our alternative credit managers, for example, could have skill both in some of the more liquid, sub-investment grade opportunities and some of the more illiquid opportunities within a single product strategy. We prefer to hire specialist managers rather than to use multi-asset funds.

In many ways, our total fund is designed to be an absolute return fund and it is not too constrained by benchmarks, but more constrained by overall risk levels. We consider the benchmark of our overall strategy to be the liability profile of the fund rather than any market driven indices. We have been using a liability driven strategy to minimise the interest rate and inflation risk, and then each of the sub-asset classes is then designed to achieve returns in an absolute return sense over the medium-term although may be market sensitive over shorter periods.

Chido: Do you have any direct investments where you don't use and managers for any of these alternative exposures?

Alan: Earlier this year we started deploying our newest strategy which we call 'hybrid assets' as it is a blend of our alternative investments and our

liability driven investment strategies. We are seeking to achieve roughly 12.5% of our exposure to these hybrid assets, and it should take us around 3 years to achieve this. For these hybrid assets, which could be much larger scale direct investments or co-investments alongside other asset owners, we take more of a direct approach.

Chido: Is that infrastructure?

Alan: It could be types of infrastructure such as long-term financing for specific infrastructure projects, but hybrids for us are not exclusively so. We also invest in infrastructure funds which are designed to be higher leveraged products and return seeking which do not fit the hybrid allocation.

Chido: Do alternative assets play a large part in your liability driven investment strategy?

Alan: Historically no, as we hedge 100% of the interest rate and inflation on our liabilities through the gilt and OTC derivative market. Like several other pension funds, we are going to start to deploy to illiquid hybrids, as previously mentioned, and splitting the risk characteristics between LDI and alternative, so our LDI approach will change over time. We will review the target allocation as our liability profile changes and as new market opportunities arise.

Chido: How often do you review this? Some pension funds can miss the boat as it can take a while for them to have meetings to discuss these investment opportunities?

Alan: Since the PPF began, we are often not the very first investor in new opportunities but certainly one of the early adopters. An example of this would be the alternative credit allocations, which we moved into quite strongly in 2010 to take advantage of some of the post the global financial crisis opportunities. Whilst others have only more recently started to come this area, we have been established in this area for some time and benefitted from good market dynamics.

> “we have built up quite a broad, skilled and knowledgeable team so it makes sense to make use of their skills and market focus. ”

We review our total allocation fairly frequently. The new target of 12.5% to hybrid assets, along with an increase in alternatives from 20% to 22.5% took place in the first half of this year, so it is relatively new. Internally, we have worked quite hard to ensure that we have an appropriate governance structure. For example, our investment committee, which has quarterly meetings, has always been very open to having any more pressing matters addressed quickly in ad hoc meetings of approval processes. A lot of the day to day powers are delegated down and into an internal Asset and Liability Committee who meet monthly. Similarly these are called upon to meet more frequently as and when particular market issues or opportunities occur.

A lot of the day to day management is delegated down to the Chief Investment Officer and investment team so the individual portfolio managers can make decisions, particularly around incremental funding or reducing funding of pre-approved mandates. Over the past 4-5 years, we have built up quite a broad, skilled and knowledgeable team so it makes sense to use their skills and market focus.

Chido: That it is very advantageous. I am not sure there are many organisations with that same setup.

Alan: Some of the larger, more established, players certainly have very good internal teams which have reasonable levels of delegation from their board of trustees. We have a slightly different governance structure than a traditional pension scheme has (for example we have a Board rather than trustees). The legislation that governs the PPF is similar to most pension funds, but there are a few elements which mean that we have delegated authority from the Board to make decisions on the ground rather than having to refer them back to infrequently meeting committees.

It has been a learning process for us. We were set up in 2005/06 so we are less than 10 years old and are a £16.3 billion fund (to March 2014). We continue to grow at roughly £2 billion per annum which has meant that over the past few years we have had to change, improve and enhance the team and governance structure, as well as the scale and complexity of some of the mandates that we award.

We have clearly been able to start small but think in big institutional fund terms, and now that we have grown to our present size, we have requirements to get the best out of our investment strategy, given the size of that strategy. It means that we can research and undertake investments which unfortunately some of the smaller pension funds would find less cost effective to do. In some ways engagement in activities, such as the Pensions Infrastructure Platform, will mean that we can help smaller funds to access this “large fund” advantage and we actively support these cross-industry collaborations.

Chido: Thank you for taking the time to share your insifghts on this.

2.2 INTERVIEW

What level of responsibility and choice over assets should a non-professional alternative investor take when allocating to alternatives?

Interviewer

Chido Tagarira
Senior Publisher, Clear Path Analysis

Interviewee

Fredrik Törgren
Former Head of Private Equity Funds & Financial Institutions, Swedfund

Chido Tagarira: How would you define alternative investments?

Fredrik Törgren: I would describe alternatives as private investments such as private equity, direct debt, syndicated loans, real estate, etc. Essentially, they are any form of unlisted assets.

Chido: How much responsibility and choice over which alternative assets to invest in should an investor without prior experience take?

Fredrik: There is a big difference when doing direct investments and investing in real estate. In terms of other types of private equity, you need to have a different skill-set within the organisation not least when it comes to legal arrangements and structures. It is very different to working with listed equities and bonds.

If you are a rookie within the alternative investments space, the indirect route might be a good initial step and then taking it to perhaps co investments with general partners or any other way to learn the job. If you are a small scale family office and you don't have many people within the organisation with the correct skill-sets, then the indirect route is the only route that I would recommend.

Otherwise, if you go the direct route you would need external consultants. In either case, you would need some kind of consultants to support you in the processing and also in the management of the investments over time.

Chido: Would you say then that it is worthwhile investing with a manager rather than going directly depending on the size of your organisation and resources?

Fredrik: Exactly, it depends on your scale and internal resources and skill sets.

Chido: What are the key factors that will determine which alternative assets will be suitable for an investor's portfolio?

Fredrik: It is important to take into consideration whether it is long-term versus short-term. If you are a large endowment, having yields or coupons in your assets might not be as important if you have a rolling investment scheme in place. However, if you are a pension fund, then having the yield or annual coupon might be important for managing redistribution to your stakeholders.

In the shorter term, it is important to have a dividend yield or bond coupon from real estate investments. So unless you have a very large scheme that has rolling or reoccurring exits in your scheme then dividend will not be as important, but otherwise having dividends or interest coupons from real estate investment is quite important for the long-term. And they are also a key factor in determining how you construct your real portfolio and how you want to have your allocations within alternatives.

Chido: What would you say is a reasonable percentage allocation to alternatives for a pension fund?

Fredrik: There have been discussions about 60/40 or 70/30 splits with equities and bonds which seems to be the general rule for a number of pension funds. In many respects, the alternatives have outperformed in many different asset classes. So my recommendation would be to have a fairly high proportion in alternatives if you have a long-term view on things and are not stressed about having short-term, but are willing to construct something over the longer term. Investors may have different opportunities to allocate optimally due to policies or based various asset classes risk weighting.

Chido: Do you have any final thoughts on this topic?

Fredrik: You can look at the academic research but it is very much dependent on your internal skill-sets as well. One shouldn't underestimate the extra work that is required to do private equity or unlisted investments as it requires a lot of different skill-sets and so it might be more useful to go the indirect route.

Chido: Thank you for taking the time to share your thoughts on this topic.

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PICKING APPROPRIATE ALTERNATIVE INVESTMENTS FOR YOUR OBJECTIVES

3.1 EXPERT DEBATE

How are investors picking amongst the various investment vehicles that allow for exposure to alternatives?

3.2 INTERVIEW

Considering an experienced investor's expectations at the outset against the real outcome of their alternative investment strategy

3.1 EXPERT DEBATE

How are investors picking amongst the various investment vehicles that allow for exposure to alternatives?

Moderator

Chido Tagarira
Senior Publisher, Clear Path Analysis

Panellists

George Finnie
Investment Manager, Strathclyde Pension Fund

David Adkins
Chief Investment Officer, The Pensions Trust

Chido Tagarira: How do you define alternative investments?

George Finnie: In some regards, it is a negative test. I look after what we refer to as the New Opportunities Portfolio (NOP) within Strathclyde Pension Fund and that considers potential investments that don't fall into our three main "pots" which are equities, fixed income, and institutional property. So the NOP is effectively our alternatives allocation at the moment. Alternatives are effectively defined by how our strategy is currently implemented.

David Adkins: We are similar in that alternatives to us are any growth assets that are not a plain vanilla equity or bonds. Our liability focused assets are gilts, LDI and sterling investment grade corporate bonds. Anything that isn't a liability focused asset is a growth asset.

Interestingly, property falls into what most people would call alternative assets these days but 30 years ago it was a mainstream asset class.

Chido: George, how do you look at property as you do not consider an alternative do you?

George: There is a large amount of property within the area which the main fund looks after, which are the traditional core assets. Then, within the portfolio that I look after, there are more alternative opportunities like the smaller property funds that are more localised and less plain vanilla assets.

Property per se is not necessarily an alternative asset, but there are some types of property that we would view as alternatives. It is those that need work, a bit of capital expenditure, and typically more effort put into them that we would classify as being on the alternative side. This is in comparison with, say, core assets in the South East of the UK, for example, that come with steady returns and relatively obvious strategies.

Chido: What are the various ways in which institutional investors can access alternative investments?

David: We are quite a large £6 billion pension fund so we are privileged to have a variety of ways to access alternative assets from the ordinary pooled funds through to segregated mandates (sometimes called single investor funds). We don't have a prior view as to which one we prefer, although we have tended to drift towards the single investor fund setups because they enable us to have a bit more say when it comes to responsible investment policy. If it is a single investor fund, we can set criteria that we can push into the mandate that you could not get from being in a common pooled fund.

In our fund of fund hedge fund mandate, we have a right to veto over fee structures that exceed certain thresholds, and we also get disclosure on exposures to carbon intensive assets as part of our climate change policy.

Chido: Do you invest in ETFs in anyway?

David: No we don't as we haven't found a need to go down an ETF route. For a retail investor, ETFs are great as they are a cheap way of tracking an index but at the institutional level, a large fund can strike a better deal with a large passive tracking index manager than you would get through an ETF. There is no fee advantage to us for using an ETF structure.

George: Indeed, as David mentioned there is the pooled fund route which is the traditional way, and we are also invested in a single fund investment structure on the alternatives side. We are starting to look at co-investments and to consider direct investments. We have undertaken direct investment for the construction of the Athlete's Village at the Commonwealth Games site, where we bridged the construction, and we now hope that there will be other things that come along that will offer similar opportunities. However, to some degree it does come down to the skills and resources that you have onsite which allows you to be able to do these types of deals, rather than picking up on a pooled fund where a lot of the work is being done for you.

Chido: How do you decide which types of alternative assets to allocate to? Do direct versus indirect questions make any impact, or are there other factors that you consider?

George: With alternative investments, people tend to come to you looking for investment so it is usually obvious from the start whether it is going to be a direct, or potentially single fund type of situation. To some degree, the structure doesn't always matter as you are looking through to the product and investment and if this makes sense, then you can generally structure it in some way or form that will work for you.

We try not to get too hung up about the structure. As long as we can be comfortable legally (in terms of Investor protections) and commercially, then that usually is fine for us.

Chido: So how do you consider which alternative assets you are going to allocate to?

George: There is nothing proscriptive to say that, within the NOP that I look after, I have to invest 20% in renewables, 10% in private equity, etc. We do try to keep the NOP within a reasonably broad balance and not to get overpositioned in any one particular asset type, but a large part of it comes down to opportunity and what appears as a good opportunity at the time.

The portfolio was set up to try and give us the ability to be a bit more nimble with areas that may have passed us by in the past, so there isn't a hard and fast percentage base relating to specific sectors that we have to do, it is more about what comes along that is interesting and taking opportunities as they arise.

Chido: David do you have a specific allocation or limitation at all?

David: We break down our alternatives into liquid and illiquid assets. The dividing line is anything that we can turn into cash within 6 months we put into the liquid bucket, and then by default, anything else falls into the illiquid side. On the illiquid side, we have several property mandates and a couple of infrastructure mandates. We have also set up a specific fund called the inflation-linked growth fund which looks for specific contractual inflation linked cash flows from a variety of interesting sources. For every £5 that we have in alternative assets, it will broadly be £3 in the liquid side, and £2 in the illiquid side.

Historically we have had quite a high exposure to equity risk premiums so we try to think about return risk premium sources. So as we have diversified, we have accessed manager skills through hedge funds, credit risk through emerging market debt, and insurance-linked securities for the insurance risk premium. Over the last few years, we have built up quite a range. The one that isn't there that some may consider to be missing is private equity. But, as an investor that has quite a lot of equity beta, having leveraged equity beta isn't at the top of our list of things to do.

> "The portfolio was set up to try and give us the ability to be a bit more nimble with areas that may have passed us by in the past. . . "

Every quarter we sit down and decide whether we are going to strategically alter the balance between the things that we have already put in place within the portfolio, and that is a regular capital market decision. The actual structure of the fund is not really a consideration as you simply find the best ways of executing the strategy after deciding what the strategy is going to be.

Chido: Do you have diversified growth and multi-asset funds in there as well?

David: Multi-asset funds come in many guises and sometimes it is only a name that differentiates one from another. But we do have multi-asset funds in a variety of guises from absolute return mandates to fund of hedge funds.

George: We do have them within the main fund but within the NOP, we don't. This is primarily because the NOP is a fairly broad church in terms of what we are looking at, and we can probably get the spread and diversification that we are looking for without going down the more formal diversified growth and multi-asset fund route.

Chido: Do you feel that most of the investment vehicles that allow for exposure to alternatives are easily accessible for institutional investors?

David: It is easier in the liquid space because of the explosion in the use of diversified growth funds. The more liquid side means that there is more capital out there that can be accessed in a readily available format.

Smaller funds do face difficulties in getting access to the less liquid asset classes. I mentioned our inflation-linked growth fund which was an idea that we set up and got a fiduciary manager in BlackRock to manage this. One of the reasons that we chose BlackRock was because we thought that more of the idiosyncratic opportunities that may arise would be more likely to cross their investment desks than possibly some other managers.

As pension funds are slow moving, you don't necessarily get to hear about certain things until it is too late and then you find out that a large insurance company has hoovered up the opportunity, in infrastructure debt for example, long before a pension fund has been able to make a decision.

If it is harder to access, it will be in the illiquid space. We have deliberately set up this arrangement so that we don't miss out.

Chido: Do you feel that it is suitable for some of these smaller schemes to have that much allocation in some of these illiquid assets?

David: I don't see why not unless there are some super mature funds where any illiquidity at all is in appropriate. But, most closed pension schemes have got several decades left to run off on their liabilities so that even if their illiquidity limit is set at quite a low level, let's say 10% of assets, that is still north of zero so I don't see why not.

Chido: George, do you feel similarly?

George: I do. The smaller the scheme, the more difficult it becomes to get into some of these situations. We are a fairly large local government pension fund but with our infrastructure allocation, when you are viewing that against the likes of the Ontario Teachers' Pension Fund, then everything does become relative.

It can also become an issue in getting the appropriate products because there can be a great deal of capital chasing some of the larger opportunities. However, as people tend to find us, we generally don't have huge issues in finding different opportunities to consider.

David: We have plenty of people that are trying to sell opportunities to us. Our job is to sort out the weak ones from the good ones.

Chido: Thank you both for taking the time to share your thoughts on this topic.

"The smaller the scheme, the more difficult it becomes to get into some of these situations. "

3.2 INTERVIEW

Considering an experienced investor's expectations at the outset against the real outcome of their alternative investment strategy

Interviewer

Pádraig Floyd
Freelance Financial Journalist

Interviewee

Anders Strömblad
Head of Alternative Investments, AP2

Pádraig Floyd: How much of your investment portfolio do you allocate to alternative asset classes?

Anders Strömblad: Within our alternative assets exposure, we have real estate and that comprises 3 different parts on our portfolio: conventional real estate and unconventional real estate, which is either farmland or timber.

The other part of the portfolio is private equity which is easier to define. We also have a portfolio which is called alternative credit and that is mainly leveraged loans, high yields bonds and structured products in a mixed mandate.

We have investments in China A-Shares that are also defined as alternatives, and we have a portfolio which you can call 'alternative risk premium'. This is where we place alternative risk premiums in one portfolio, such as a couple of hedge fund betas for example, as well as insurance-linked securities, all put together with an optimiser.

All of these assets together currently make up 16-17% of the portfolio with the majority in real estate (10%), as well as private assets (4%). The alternative credit allocations are close to 2%, whilst China A-shares allocations are below 1%, and alternative risk premium is the last 1%.

When it comes to private asset classes like private equity, we are regulated by law which states that we are not allowed to have more than 5% in these assets, so we are just below this cap (private real estate is not included in the 5% limit).

Pádraig: If you had the opportunity, would you like to do more?

Anders: Indeed we would like to do more if we had the opportunity, but we have balanced out what we have today. We are in the process of increasing the real estate portfolio in all of the 3 lines that we have over time, but in our asset allocation, we use a balanced approach so we don't rush into anything and we don't change the asset allocation until we have made the investment.

Having a medium-term goal with a real estate portfolio in these 3 lines means that we are happy to move up from the 10% that we have to 15% if we find good investment opportunities.

Pádraig: Is this imposed 5% cap just on private equity, or is it on other parts?

Anders: It is on all private investments, with the exception of real estate. With the other parts of our portfolio, like China bonds, etc., they are all tradable assets but we still define them as alternatives (because they are harder or impossible to be a part of the normal portfolio rebalancing).

Pádraig: What were the drivers and expectations for investing in these assets when you first allocated to them? Have these expectations been met?

Anders: The private equity investment has done well and we hope that it will continue to do that even if it is an asset class that has had a lot of changes. Looking back to 2001, there were various changes to the asset classes.

Over time, we think that the emerging markets, China included, will have a significant part of the world's wealth which is why we want to be there. It is still early today, so we have taken a long-term view with this mandate.

With alternative credit, our assumption is that there will be big gains similar to those in alternative listed equities and credit portfolio. The majority is secured and we think that this is a better place on the balance sheet. It also allows us to take advantage of the changes that are now happening in the European credit market, and partly in the U.S credit market, where we are seeing a big swing from bank financing over to institutional financing of corporates. So far, this portfolio has done well, and even though it is still early days, it is doing what we expected it to do.

The attraction to real estate is because we assume the long-term return expectations to be at the same range as listed equities, but with more downside protection and less high volatile assets.

When it comes to agriculture and timber, due to the global population we think that there will be a rise in middle class which will change how people consume as they will consume more wood, fibre, and other types of product.

A long-term view in real estate with places like London, New York, Los Angeles, etc., will also be a good play.

Pádraig: Is it fair to say that all of your expectations have been met by those different sub classes?

Anders: Yes at least for those that are old enough to be measured in a proper way and in a way that we think is justified. With China, it is too early to tell.

Pádraig: With Asia, countries like Vietnam are really pushing into that emerging market bracket anyway and China are investing a lot in there themselves.

Anders: Yes and on the public side, we have increased our exposure to emerging market equity in China as well.

Pádraig: Are there any other significant alterations you are looking to make in terms of your current exposures or is it going to be steady for the foreseeable future?

Anders: We will be investing very steadily, but if there were any changes in regulations, we will probably consider putting more money towards private equity as long as we can see that we can outperform the public market. I assume that if the regulations change, we will take a look at infrastructure as well although we would have to take our time with this before making any investments.

Pádraig: Do you anticipate a potential in your government's stance on private investment caps because we have seen a change in attitude from government in the UK and other countries around the world that are very keen on getting private investment into this type of public funding.

Anders: Absolutely but that is work that we need to do. There is an enquiry going on which started 2 years ago where the suggestion was to consider changing the limits that we have on different types of asset classes. We are presently not allowed to invest in commodities, we have a 5% cap on private assets, and must have at least 30% in liquid and low credit risk bonds, so they are considering changing this. But whether that will actually happen is uncertain.

Things may change but we are not sure exactly how.

Pádraig: Thank you for taking the time to share your views on this topic.

"we will probably consider putting more money towards private equity as long as we can see that we can outperform the public market. "

SECTION 4

THE ROLE OF ALTERNATIVE ASSETS IN A DEFINED CONTRIBUTION SCHEME

EXPERT DEBATE

How suitable are alternative investments for a defined contribution pension scheme?

How suitable are alternative investments for a defined contribution pension scheme?

Moderator

Pádraig Floyd
Freelance Financial Journalist

Panellists

Jeremy Stone
Chair of Trustees, WH Smith Pension Fund

Nita Tinn
Director, ITS

Chido Tagarira: To what do you attribute the growing interest and allocation to alternative assets from defined benefit (DB) pension schemes in recent years?

Nita Tinn: Falling interest rates and volatility in equity returns has increased the need for trustees to diversify and increasingly trustees are looking to alternatives to play a part in their portfolio. Assets such as infrastructure which have a linkage to inflation and can provide some degree of liability hedging are an obvious source of interest, particularly as both developed and developing economies look to institutional investors to fund these projects.

Jeremy Stone: There has been a growing short-term correlation between all of the traditional asset classes in recent years. Therefore, investors have tried to look for less-correlated assets in order to get more funding stability. They are searching for assets that are unlisted, or not particularly interest rate sensitive, etc. Anything that ticks one of those boxes qualifies as an alternative asset.

Chido: With property, some now consider this as a core asset but then there are some who consider property to be an alternative asset. What's your view?

Jeremy: It is a grey area because with property, it very much depends on how you buy it. Typically, there is a compromise between equity and bond behavioural characteristics because if you have a fairly high rental component in the value when you buy it, it will be relatively bond-like in its behaviour and that will produce more yield than a bond of similar credit exposure.

Property is a somewhat distinct asset class between equity and bonds. There are other types of alternatives like commodities, farmland, etc. where you can make an argument for having various properties that you haven't got from one of the other asset classes.

Nita: It depends what you mean by "alternatives". Property has generally been considered a core asset as it has formed a part of pension scheme portfolios for many years. We tend to think of alternatives as newer, less familiar asset classes such as currency, infrastructure, etc. which generally form only a small part of a typical portfolio. Property is generally seen as a growth asset although if held for rental yields it can be more bond like in characteristics.

Chido: So the growing interest in alternatives comes from the diversification aspect in finding these lesser correlated assets?

Jeremy: It is not just diversification that's driving the interest but it is also the difficulty in finding return. The fact that you have this generalised 'risk on/ risk off' phenomenon which makes everything correlated means that you are driven to find more exotic alternatives in order to get genuine absence of correlation. It has also been very difficult to find a good margin of expected return above the risk-free rate and this is another element that is driving the search for different asset classes.

Chido: Do you feel alternative investments have a place in a defined contribution (DC) pension scheme?

Nita: I think there is an obvious correlation between the use of alternatives to dampen volatility whilst preserving returns, and the requirements for DC investors not to lose money. The use of diversified growth funds for the accumulation phase in DC (either on their own or mixed with an equity tracker) has increased in recent years and although this may lead to some loss of upside in the early years, capital preservation in the later years is potentially more important. The obvious concern is cost as these funds typically have an AMC of around 75bps which is at the cap already before you consider TER and administration fees. We are seeing some movement on fees with more strategies offering a range of passive equities with some active diversifiers which can reduce the fees to around 50bps. However, most DGFs are still heavily equity biased and it is not until you go into the hedge fund space that you are likely to get significant diversification away from equities in terms of absolute return funds, and the cost of these together with the illiquidity puts them outside of scope for most DC pension schemes.

Jeremy: I definitely do. One of the things that has been distressing about how the DC pension world has developed is the idea that there should be very few and simple assets to choose from, with correspondingly highly correlated investment characteristics. If you come from the DB perspective, where you have the opportunity to try and sculpt the

portfolio to get the characteristics that you want, then the DC world can be quite difficult as you have a restricted range of assets available.

Alternatives do have a place in DC, although there are traps to be wary of. For example, I know of a scheme that closed its DB scheme to new entries and had a rising number of DC members. The trustees of this scheme looked at their DC offering which was a traditional mixture of bond, equity tracker funds, as well as a few actively managed alternatives. They felt that it wasn't going to produce the right long-term mixture of stability and asset growth on average because the volatility of equities, in particular, was too high for smooth increasing (which is what they wanted to offer their members). As bonds were very expensive, it was bad value to be investing in them long-term and they had serious re-investment risk. So with consultants' support, the trustees decided to identify the best-in-class diversified growth funds and make that the default offering. If it is properly managed, the dynamics of that are probably better than having the mixture as before. It was made available so that members would get something reasonable if they chose the default, which is important because members almost always end up picking whatever the trustees or managers decide to be the default.

The drawback of this important decision to default to diversified growth funds was the very big management fee on it. One of the members of the scheme, who was financially sophisticated, came to me in a state of perplexity and felt completely outraged that the trustees (of whom I am not one) could possibly do this. The member was many years off retirement so his view was that he could afford the volatility of equity, and so he should be in trackers rather than being moved out into something that had 100 basis points+ going out of the door every year in management fees, in order to produce something that he didn't need.

The moral of the story is that there is definitely a place for these alternative type of assets because direct investment in uncorrelated assets is very difficult to do in a DC format. But, it definitely has areas of weakness, one being that it is expensive.

Chido: What you are sacrificing in return for stability is the cost then?

Jeremy: Indeed. You can do some simple simulations and see that provided it produces the returns most of the time, it will get the scheme members to a better retirement place than they would have got with equity trackers. But, it will slice off their upside tremendously.

Chido: What types of alternative assets would be more suitable for a DC scheme?

Nita: My concern is that many of the really useful assets classes such as infrastructure and property are being overlooked in DC due to the requirement for liquidity whereas in truth most DC investors do not actually need daily dealing of their funds as they are likely to give at least three months' notice of intention to retire, thus giving sufficient time to liquidate assets. The other issue is, of course, the manner in which DC investors' access funds which is usually through an insurance policy with a platform provider, rather than a direct investment with a manager. Most platform providers will provide access to property funds, and there is every likelihood that other asset classes can be made available in time, although there is an obvious cost in accessing alternatives in this way. My prediction is that we will see a growth in alternatives through structured DC products such as target date funds where asset allocations are managed over time to suit the perceived investment needs of the member during their savings lifetime. i.e. if they are in a target date fund targeting drawdown we will see a gradual shift to more bond like investments such as property and infrastructure within the portfolio by the time they come to take an income.

> "Alternatives do have a place in DC, although there are traps to be wary of."

Jeremy: It is very difficult to get anything into a DC scheme unless it is wrapped up in a fund. You start off with one veil between you and the alternative asset, which is that it has got to be wrapped up in some fund that you're actually allowed to have on the platform. There are going to be concealed management costs as there seems to be a problem with transparency, but I don't see a way around that. So within that fund, there are various things that you can try to do such as attempting to provide a management style-type of exposure to multiple asset classes that you get in a diversified growth fund or multi-asset fund. Or, you can offer a range of relatively pure asset class commodity funds, farmland, etc. and people certainly buy them if they are available on the platform.

Ultimately, there will be infrastructure or other things that produce rental streams like property, but in a different way through different exposures and covenants.

Chido: Besides the diversified growth and multi-asset fund route, are there any other types of

investment product that could be put forward by investment managers for a DC scheme to gain exposure to alternatives? Could you have standalone assets as opposed to always having something that is wrapped up in a diversified growth or multi-asset fund?

Jeremy: There are, and will be, more of single class managed assets. You can buy credit-type products, corporate bond funds, asset-backed bond funds, commodity trackers etc.

Nita: I think we will see a move away from single asset funds towards structured products as the cost of the former will be difficult to maintain in a world where there is increasing downward pressure on cost for default options. It will be a hard sell for managers to justify charges of 1 or 2% when the charges cap on the default option is 75bps. Whilst the pressure on charges may have a negative effect on the range of asset classes on offer there is likely to be a better choice of products due to the need to cater for different retirement profiles in the post budget era.

Chido: Do you think that more trustees will be adopting the alternatives in the DC scheme idea, or will some of the traps such as the concealed management costs keep it quite far off their horizons?

Nita: I think trustees who already offer a range of standalone options alongside their lifestyle defaults will continue to offer asset classes such as property and maybe the odd esoteric asset class such as commodities, but I do not see a huge growth here, if anything the range of asset classes on offer will diminish as members do not generally make full use of the choices available to them. Trustees are being forced to look at their default strategies as a result of the budget changes, and it is here that they will focus their energies by offering alternative strategies aimed at targeting either cash, drawdown or continuing to stay invested alongside the traditional annuity routes. It is within these structured products that managers are likely to make more use of alternatives.

Jeremy: I'm not sure. Due to the pension reforms that are currently going through and prospectively over the next few months, trustees are looking at what is the appropriate way of providing for DC, what is the meaning of providing a default fund, and how do you make that suitable to people who have different perspectives on how they are going to use their DC scheme.

At the moment, there is unfinished business, which is necessary as we don't know enough about the rulings, but sometime over the next 6 months to a year, I think the landscape will look quite different. At the very least, it will no longer be tenable to provide, as first generation DC schemes did, 1 or 2 equity options and a lifestyle fund.

Chido: They need to revamp it a bit?

Jeremy: They need to radically revamp it because the obligation to provide default funds will remain. It is complicated, and I am not sure what the architecture for that is as it may well be that you can't offer 1 default fund and might have to carve up a DC scheme into 3 or 4 parallel chunks so that people can make more than 1 default choice. However, I do know that it is very unlikely that the simple life will continue to be one of the options.

Chido: Thank you for taking the time to share your thoughts on this topic.

"we will see a move away from single asset funds towards structured products. . . "

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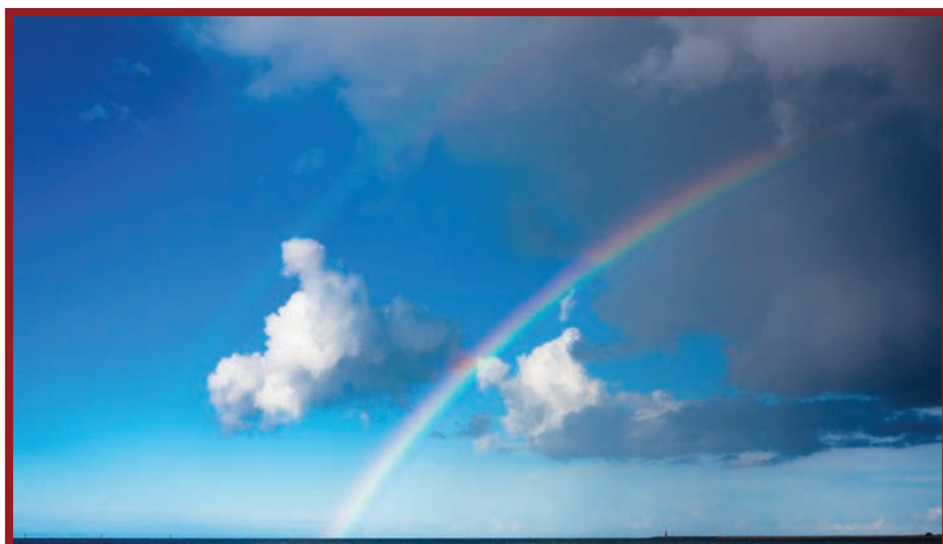

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