SPECIAL DELIVERY

The Royal Mail Pension Plan took its first hedge fund steps last year and isn't finished yet. *HFMWeek* talks to alternatives specialist Bev Durston about the British institution's unconventional approach

BY KIRSTIE BREWER

While UK pension funds may be considered conservative investors relative to their North American counterparts, some British institutions have been building a reputation for treading less familiar ground. Chief among local innovators has been the £3.6bn ($6.0bn) Royal Mail Pension Plan (RMPP).

London-based RMPP was one of the three largest pension schemes in the UK in 2012. But in the face of a burgeoning deficit, the government nationalised its debt and took on around £29bn of its £31bn assets. The new-look plan – leaner and fully solvent – is able to allocate more dynamically and last year hired Albourne as part of its first foray into hedge funds – or absolute return funds as it refers to them. It has already spent $150m on debut investments and there's more capital to put to work.

In a further sign of intent, the plan last summer hired seasoned investor Bev Durston, five years the head of alternative investments at British Airways Pensions, to take the helm of its alternatives portfolio. Durston is currently scouring the globe for the next crop of investments, making travel a vital part of the process. Just as well – she's based in Sydney, Australia.

"The managers who visit there tend to already have existing Australian clients and so offer only a limited universe to compare from. After the last seven years spent covering London and US managers I already have a much wider network of possible managers," she tells *HFMWeek* from RMPP HQ during one of her many trips to London. "I strive to cover the world."

Durston returned to Australia in the summer to set up her own consultancy firm, Edgehaven, where she dedicates half her time to RMPP and its growing alternatives programme. Frequent travel and access to good alternatives databases is important in finding the best possible managers, says Durston.

An Australian expert advising a British institution on US managers. If it sounds a novel approach, it's been noted before, she admits. An interview room adorned on the outside with the giant figure of Postman Pat – a British cartoon character with an apt profession – adds to the unconventional set up.

But then a fresh approach is exactly what RMPP wants – and what brings Durston to London. Making use of her global perspective, not to mention Sydney base, RMPP is keenly exploring Asian opportunities. "If you can add an Asian flavour which is on a different cycle you get better diversification," says Durston, highlighting the current dynamics in Europe and US.

"We have added two Asian managers to date and continually look for interesting managers in the region," she confirms, conceding that as long/short equity isn't something RMPP is focused on there are slimmer pickings. Africa is also on the radar, but is a play more likely to fit in the private equity portfolio, she says.

TAKING THE PLUNGE

For many UK pension plans, exposure to hedge funds, let alone an emerging or frontier markets hire, remains an adventurous dilemma. On the ground at last week's annual UK National Association of Pension Funds investment conference, the sector's conservative nature was again laid bare – albeit split along corporate and public lines (see box, right).

"I think the sentiment from UK corporates towards hedge funds is getting stronger," says Christopher Parkinson, head of manager research at Cardano, noting the move from FoHFs to investment consultants or even in-house. The growing use of fiduciary management could also mean additional hedge fund allocations. "As this growth continues in the UK, US and across Europe we would expect more and more pension funds to use hedge funds and for those that do, to have higher allocations to them – this is not because hedge funds per se are an attractive asset class, but because hedge funds can present an attractive way to access the different asset classes."

Christy York, Emea head of capital introduction at Citi, and his team are seeing corporates in the UK follow their US counterparts and move hedge funds into core equity and core credit, which usually means larger allocations to managers, he tells *HFMWeek*.

In this respect, RMPP is already several steps ahead of its peers. Last year, the plan's first CIO – April hire Ian McKnight – oversaw the allocation of around $100m across five managers: New York-based duo Halcyon Asset Management and MKP Capital; Swiss commodities outfit Krom River; Chicago-based Elementum; and Hong Kong outfit Pacific Alliance Asia Opportunity Fund, sources familiar with the matter told *HFMWeek* at the time.

With Durston now steering the ship on alternative investments, another $50m has been added and two new absolute return fund hires are currently being signed off. Before the government transfer, RMPP employed 12 principal managers – multi-billion dollar shops including BlackRock, Standard Life and Hermes. However, a move into emerging managers could well be on the cards.

"Once the hedge fund exposure is built and we are comfortable with it, the next stage might be to add an emerging manager portfolio, via a specialist solution provider (such as a FoHF) in order not to overstretch resources," says Durston. "There are of course operational risks with smaller funds to be mindful of but there is also an argument that managers are leaner, more nimble and keener to build the track record at the early stages."

Event driven, structured products and macro funds are all areas of interest, notes Durston, who reiterates the importance of small, flexible teams. "Cheap" beta can so easily turn into "dumb" beta unless institutions have either skilful managers or good market timing skills internally," she adds.

When looking at a prospective investment, Durston begins with the structural elements of the firm, considering remuneration and incentive policies, ownership and management dynamics. "These initial items determine whether or not I am interested in taking matters further in the first place," she tells *HFMWeek*. Specialist firms are preferred with one main product offering and their own money invested as this tends to promote better alignment of interest, she says.

For RMPP, Durston scores managers using a disciplined quant-based system, mixed with a qualitative overlay. "It's part art, part science and includes overall a number of criteria such as firm-wide and organisational elements, people and resources, investment process, risk management, implementation and, of course, the specific product offering and terms."

Bev Durston was head of alternatives at British Airways Pensions between 2008 and 2013 and during this time was also a member nominated trustee for the Corporate Defined Benefit pension fund. For two years prior she was a senior portfolio manager for the Government of Singapore Investment Corporation (GIC) and has worked at Australian superannuation schemes, including Sunsuper as deputy CIO. Durston's resume also includes stops at Queensland Investment Corporation and BT Funds Management, where she was head of portfolio risk management. While Edgehaven has a natural bias to Alternatives, Durston's trustee experience and broader investment skills have also led her to consult on pension fund design, risk management and multi-asset class investing.

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It's rare that a firm will score highly on each of these areas, she admits, "but I like to understand where the firm's strengths are and where I am trading off lesser capabilities. It also reveals my own biases and summarises what I like best about the firm," she explains.

Targeting low beta to equity and credit, RMPP's hedge funds are placed within a dedicated alternatives bucket. The diverse portfolio – covering vehicles from direct lending and mezzanine finance to emerging market distressed debt – targets an 8% return but a minimum of 5% in the current down market.

Achieving these gains is no mean feat, admits Durston. "With no beta to credit or equity markets, low leverage and the requirement of small drawdowns this is a difficult task because you need to find sustainable and persistent skill." Durston's track record bodes well at least. During her five-year tenure at BA, the alternatives portfolio made an annualised 16% return, with 6% volatility.

GOOD CORPORATE CITIZENS

Transparency and good governance are important elements in any investment made by RMPP. It is already a member of the UN Principles for Responsible Investment and is imminently due to join the Hedge Fund Standards Board. The plan is also an advocate of Albourne's transparency initiative, Open Protocol. "Transparency between now and five/seven years ago is like chalk and cheese – standards have improved, but on the flip side, fund documents still have a way to go to become more standardised and investor friendly," she adds.

Durston says she is beginning to see AIFMD take its toll on opportunities for European investors – a reality she calls a "disturbing" trend. "Hedge fund managers over in the UK are requesting information before they open their books and I think it may start to become a drag on opportunities for European investors," she explains. "If an investor like Royal Mail has to fill in a lot of paperwork in order to see a manager, before even knowing whether they are of interest, it's going to become increasingly complex and burdensome," she warns.

"It might be a hapless job, but hedge fund managers of institutional quality can do their part to educate the wider industry about risk management skills. Good hedge funds have this built into their DNA." In a conservative UK pensions industry, the approach of RMPP and Durston can offer a lesson in itself. ■

PENSION PAINS

The 2014 National Association of Pension Funds (NAPF) Investment Conference took place last week, with hedge fund sentiment tepid at best. While alternative strategies such as farmland, infrastructure and emerging market debt dominated discussion, hedge funds were notably absent from the official agenda: a reflection of the NAPF's 2013 annual survey, perhaps, which found that the average DB scheme reduced its hedge fund allocation from 4.1% in 2011 to 3.3% at the end of last year. Sentiment from the conference floor, however, served to highlight the growing divide between the corporate and public approach.

Many of the public pension fund representatives *HFMWeek* spoke to at the event didn't think the diversifying benefits of hedge funds were a compelling trade-off for the high fees and volatility they are perceived to involve. Others harboured ethical reservations or thought they were just too risky. The £13.5bn ($22.6bn) Strathclyde Pension Fund takes its main risk in equities, with exposure to an absolute return product run by Pimco that is probably the closest the scheme gets to hedge funds, explained Richard Keery, investment manager. He said trustees at the fund were "rather reluctant participants in the capital markets" and that, where possible, they tried to steer investment away from the City of London.

There were some large corporate players in attendance who have meaningful exposure to the space, including the £14bn ($23.4bn) Shell Pensions Trust, which has a roughly 5% allocation. Robert Craig, a representative of the fund, said his team were "fairly satisfied" with the exposure they had built up over the past five years and were sticking with their investments.