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# Investment Insights

## Alternative asset classes – what are they and do they have a role within pension scheme portfolios?

Quarter Three - 2015

The purpose of this quarter's Investment Insights is to consider the alternatives market and assess what, if any, role alternative assets could play within a pension scheme's portfolio.

There has recently been much discussion about pension schemes investing in alternative assets, and we raised the issue in our Q4 2014 Insights note.

In many ways this is nothing new; the story has been rumbling on for the last 15 years, from the initial Myners review into private equity through to George Osborne's most recent infrastructure plan.

In that time very slow progress has been made in terms of increasing direct allocations towards such investments. Is it time for a change?

### Definition

What asset classes are we considering when we talk about alternatives? Well it depends on who you ask and this gets to the crux of the problem. The alternatives market could be defined as anything other than traditional equity and bond markets. But that covers a huge multitude of markets and so our focus in this note is on illiquid, private markets.

We see the range of assets under consideration as:

| Private equity | Private debt | Infrastructure | Property |
|---|---|---|---|
| Hedge fund strategies (as a potential method of accessing the above) | | | |

There are then a number of sub-asset classes within each of the above. For example; within infrastructure are you focusing on the debt or the equity, and within property are you buying the property or providing the financing?

### Consideration for trustees

*For the purpose of this note we are focusing on truly illiquid assets. However, schemes should also be aware of the potential for areas of their 'liquid' portfolio to be a lot less liquid than believed, and take appropriate action to fix this.*

## How might these be used within a portfolio?

There are two main reasons to use these asset classes; diversification and return enhancement, it is important to consider the features of each of the sub-asset classes on the previous page to assess how a scheme could use them within a portfolio.

The diversification benefits of alternatives are often overstated. In general we take the view that private equity is not a good diversifier from public equity. Equity risk is equity risk; we believe the majority of the perceived diversification 'benefits' arise out of infrequent pricing and different pricing models in private markets compared to their public equivalents.

The same is true on the debt side. The key, as we have emphasised in previous notes, is to focus on the source of the return, and risk, within the asset and not focus on the asset class labelling.

We will consider later on in this note whether the argument of additional returns holds true but before we do we illustrate in the chart below the roles the various sub-asset classes could, in general, play within a portfolio:

| | Diversifiers | | Return enhancers | |
|---|---|---|---|---|
| | Hedge fund strategies | Real assets (property and infrastructure) | Private debt | Private equity |
| Diversification | ✔ | ✔ | | |
| Income | | ✔ | ✔ | |
| Inflation protection | | ✔ | ✔ | |
| Return enhancement | | | ✔ | ✔ |

## What is the potential investment opportunity?

### Illiquidity premium

Pension schemes have long-term liabilities; however they often demand that their entire asset portfolio can be sold within a week's notice. Are they missing out on an opportunity by demanding this constant liquidity that they very rarely, if ever, make use of? An illiquidity premium, if one exists, is an additional return available to investors who are able to keep their assets invested for an extended period of time.

### Private markets

An accusation levelled at Quantitative Easing (QE) is that it has distorted all public markets; pushing down yields on safer assets, forcing investors to buy riskier credit and equities in a search for yield, pushing up the price. The original concern over QE was that it would create price inflation. In reality it has primarily created asset price inflation, as the money created has largely remained within the financial system and hasn't spread to the real economy.

If the money has remained in the public markets, but not flowed across to private markets, then there may be an opportunity for clients that are seeking higher returns to do so by taking profits on their public assets and re-investing them in private markets.

## Is this potential investment opportunity real? – Strategic review

The two investment opportunities set out above are interlinked – private markets by definition are illiquid – but does historical evidence support the view that investors can get a higher return by locking up their capital? There have been many studies reviewing whether an illiquidity premium exists. These have examined various markets; from the traditional, public equity and debt markets to the naturally less liquid private markets.

In general these show that higher returns can be obtained in less liquid assets. However, the studies are not 100% conclusive as measuring the illiquidity premium is very hard and it can be difficult to distinguish the illiquidity premium from other risk factors. This goes back to our point earlier in the paper; private equity is equity risk and it is likely that equity risk will dominate the illiquidity risk and you therefore have to be comfortable taking the former before considering the latter. Less liquid investments tend to provide a higher return; although it is far from universal. Leverage will also be a factor in this comparison.

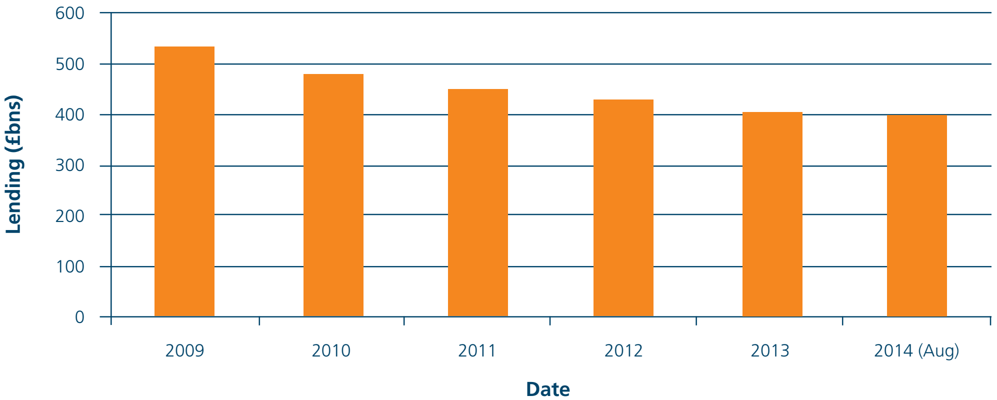
## Is this potential investment opportunity real? – Tactical review

So if structurally we feel we do get rewarded for taking on some illiquidity risk, is now a good time to invest in private markets? We currently see two competing forces within the demand side for these assets:

**Banks exiting the market** - as a result of increased regulation following the financial crisis, we are seeing banks deleveraging their balance sheets, playing a reduced role in the debt markets. This is illustrated in the chart below, which shows that bank lending in the UK to private companies fell from £530bn in December 2009 to £400bn in August 2014.

Given that this exit from the market is arguably driven by regulatory reasons rather than underlying profitability concerns, this may provide an investment opportunity for other long-term investors who are not subject to the same regulatory burden.

**Stock of bank lending to private non-financial corporations in the UK**

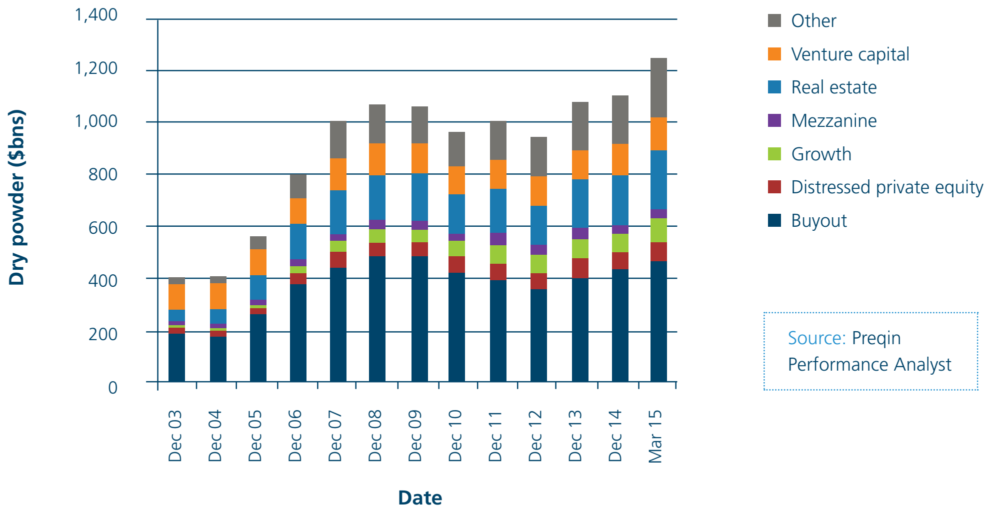



Source: Bank of England

**Other institutions entering the market** - insurance companies, for example, have been active in this part of the market and with large asset pools at their disposal have been quicker at filling the 'void' than the typical pension scheme.

There are areas of the market that have attracted a lot of capital. For example, the chart below shows that the amount of 'dry powder' sat in private equity funds awaiting suitable investment opportunities has been increasing of late.

**Private equity dry powder by fund type - December 2003-March 2015**




Source: Preqin Performance Analyst

## A focus on infrastructure

So what of Osborne's infrastructure plan? The argument is that infrastructure provides stable cashflows over a very long time horizon with a high level of inflation linkage; a seemingly perfect fit for the structure of pension schemes' liabilities. Whilst in theory, the asset class appears a good fit for pension schemes, we see the reality as being different.

### Required time horizon

A number of these asset classes have a time-frame that is simply too long for many pension schemes. This may sound unexpected but is, we believe, the case for the majority of corporate pension schemes. Regular readers will recall from last quarter's Insights that we believe the majority of such schemes have an objective to buy-out within 10 to 20 years say. Infrastructure projects and funds may well have time horizons running beyond this period and whilst liquidity may present itself in the secondary market, this cannot be guaranteed.

Building an allocation to infrastructure will take many years. Any initial investment could take two or more years to drawdown and it is likely a scheme will wish to diversify the risks across a number of funds over a period of time as each fund could be relatively concentrated.

### Inflation linkage

The inflation linkage claim also requires a bit of closer scrutiny. Infrastructure debt is, in general, much like any other debt and predominantly fixed in nature and therefore does not provide investors with inflation protection. Inflation linkage may exist, for example through revenue streams from energy projects or toll roads, but if it does it will fall to the equity holders and not the debt holders.

Again the key is defining your objectives for holding the asset class and directing your investment to the most suitable part of the market.

## A return to property

So far in this note property has barely received a mention. However we still feel this remains one of the most readily accessible parts of the illiquid market for the majority of schemes. Not only do yields still look relatively attractive at a little over 5% on UK commercial property, despite a 20% capital appreciation over the past two years, but managers are innovating and focusing on new sectors of the market.

The long lease part of the property market provides opportunities for an inflation-linked income stream above that of index-linked gilts. An area these funds are continuing to focus on is government guaranteed rental income; a number of funds target a certain percentage of income as having a government backing. By taking on some residual value risk and the political risk of 'restructuring' rental agreements a significantly higher yield can be achieved than from index-linked gilts.

### Consideration for trustees

*We highlighted earlier investment opportunities in markets where banks are no longer active. Here is an example of an investment opportunity where the government has chosen to no longer be active.*

## The challenges of accessing private markets

In order to invest in such markets there are a number of issues you would need to accept:

- **Low liquidity** - committing your capital for at least five to ten years, potentially longer for certain asset classes. Beware of funds offering the illusion of liquidity.
- **High fees** - Charges could be in excess of 1% per annum, with performance fees in addition. If returns are to be lower going forward the impact of high fees would be proportionally greater.
- **Investment time lag** - it could take two or more years for the money that you decide to allocate to a certain asset class to actually be invested.
- **Nature of the vehicle** - Do you access via an open or closed ended fund structure? Do you go for a direct or fund of funds approach? Do you select individual asset classes where you see value or do you invest across a broad range of alternatives?

### Are Pooled Alternatives funds the solution to these challenges?

These sound attractive; giving the manager freedom to allocate across the private, illiquid universe to where they see the best opportunities. This helps solve the governance burden in the same way Diversified Growth Funds (DGFs) have in the more mainstream asset classes. Whilst a few such funds were established a number of years ago, they have not been hugely successful in attracting assets and the number of funds in existence remains low. Why is this?

- **Liquidity** - the funds tend to offer quarterly dealing; which actually prohibits investment in large parts of the markets we are interested in.
- **Objectives** - Differing objectives to aim for. Is the fund designed to act as a diversifier to other growth assets? A return enhancer to growth? Or a return enhancer within credit?
- **Lack of demand** - Whilst a range of DGFs, with a range of targets and objectives akin to those set out above have launched; this range has been met by a similar level of demand. However schemes that are interested in alternatives are only ever going to allocate a relatively small part of their portfolio.

So the fragmented nature of the market, coupled with relatively low levels of demand, mean that it is not economic for fund managers to launch such pooled vehicles. We therefore see real challenges to the development of this type of fund and think that the governance burden is largely going to remain on trustees to select the asset class they feel is most attractive if they wish to move into private markets.

## In conclusion

As with everything we do with clients the starting point is your ABCs; Aims, Beliefs and Constraints. We do believe you get rewarded for illiquidity, but investing in such assets comes with many challenges. As with many markets at present, the key is being selective in how and where to gain exposure. In all cases there are very significant governance challenges to overcome before investing. So if you agree with our beliefs and your aim is to try and achieve greater returns then such parts of the market are worth considering.

However access to such markets remains a challenge:

- Pooled multi-alternative funds are few and far between at present and many managers are struggling to build such funds.
- Property perhaps remains the most appropriate investment for an initial foray into this area of investments for schemes; with the potential to look at sub-sectors of the market based on trustees' objectives.
- Multi-Asset Credit (MAC) funds (which we wrote about in our Q3 2014 Insights) that have freedom to look at the private market may also be an appropriate starting point.
- Finally, if you truly have a 20 year plus time horizon it may well be appropriate to consider an infrastructure investment further.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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