PENSION FUNDS IN ALTERNATIVE INVESTMENTS

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Low interest rates and lackluster performance of stock markets in the recent years have led many pension plans to reconsider their traditional approach to managing investment portfolios.

Pension funds need a stable funding ratio and this often translates to a need for a consistent and steady return. The most obvious way to achieve this is by diversification through asset classes that offer a decent and uncorrelated return. Therefore, pension plans have been increasing their allocation to alternative investments such as hedge funds. This trend is observed in both public and corporate pension funds all over the world. According to Wilshire Trust Universe Comparison Service, the median on alternative investments by public pension plans in the US with assets under management over 1 billion USD was 15% as of June 2012. This is an increase of more than 10% compared to last year's allocation. The increase is mostly funded by reducing exposure to volatile (long-only) equities.

Industry coming of age

The historical track record of alternative investments is appealing to long-term focused pension funds. Some pension fiduciaries, however, still refrain from allocating sufficiently to alternative investments since they are seen as exotic, risky and expensive. These investments are also less mature than their traditional counterparts (stocks and bonds), hence expertise and resources in the industry are still scarce. As pension plans are under public and regulatory scrutiny, there is a growing debate whether pension funds should pursue alternative investments. Point in case is the Dutch Central Bank that sees hedge funds as having a higher risk than equities and pushes the schemes to be in full control. Dutch pension funds should either invest in governance or divest their hedge fund investments.

Most of these hurdles are being tackled. Demands by professional investors such as pension funds have institutionalized the alternatives industry. Hedge funds discount their fees in exchange for longer lock-ups and larger ticket sizes, just like traditional asset managers do. Pension funds also influence the transparency requirements, the setup of managed account structures and the choice of counterparties. As hedge funds are increasing the liquidity and market-neutrality of their portfolios, some quantitative oriented hedge funds even provide their clients with complete transparency of their processes and securities held. Self-administered funds, once quite common in the US, now have come close to non existence. Industry initiatives such as the Open Protocol Reporting Format will impact reporting in a similar way that GIPS did to the long-only industry.

Building up knowledge and going direct

Alternatives cover a full array of investments, ranging from infrastructure projects, private equity, commodities to hedge funds. Within hedge funds, there are multitudes of strategies: market-neutral, long/short equity, macro driven, managed futures/CTA, distressed assets, relative value, arbitrage, and so on. Investing in alternatives can therefore be much more resource intensive. Yet, as the knowledge in alternatives is growing, many pension funds are setting up hedge fund selection teams to go direct where fund-of-funds would have been the preferred route in the past. Pension funds also increasingly appoint investment consulting firms to help them screening the hedge fund universe.

The alternatives industry is maturing swiftly and this is an opportunity for pension funds to achieve the kind of return and diversification that they cannot afford to miss in order to keep their promises.