Where to look for the best returns

by Åsa Norrie (co-writer Christopher Nichols)

Åsa Norrie

asa_norrie@standardlife.com

I'm often asked what markets or asset classes offer the 'best' investment opportunities for generating returns for pension schemes. While it's easy enough to discuss our research-driven house view of different asset classes and their likelihood of generating positive relative returns in the short-to-medium term, the question, and indeed the answer, is of little actual relevance to pension schemes in the longer term. My pragmatic answer to the question, "what is the best source of investment returns for pension schemes?" would be, "wherever you can find them."

Christopher Nichols

This implies an investment strategy that departs from the traditional managed or diversified growth approach. In this article, I aim to describe such an approach: a dynamically allocated, truly diversified, return-seeking strategy and its considerable advantages over traditional managed or diversified growth strategies.

Traditional return-seeking approaches

Traditional investment strategies seek to exploit the rewards of long-term market risk to grow scheme assets. Historically, schemes used balanced managed funds, while more recently, specialist asset class strategies have become commonplace. The issue with both these solutions has always been their rigid asset allocation structure. For example, a typical strategic benchmark of say a 50% bonds and 50% equities, often results in a fund which remains close to these figures, even if the fund managers have a pessimistic outlook for one of the asset classes. This outcome results from specialist asset class managers not having the discretion to make asset allocation changes. Even in cases where some discretion is given, restrictions remain in terms of the tracking error that can result from asset allocation. Managers, therefore, end up hugging the strategic benchmark, whether or not they believe it is appropriate.

Åsa Norrie is Investment Director (Scandinavia) at Standard Life Investments. *Christopher Nichols* is Investment Director (Strategic Solutions) at Standard Life Investments.

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In order to address this issue, many investment managers have begun to offer 'diversified growth funds'. These offer a more diverse range of asset class exposure than traditional funds, which can greatly enhance the funds' risk/reward profiles. Although investment managers are encouraged to take active asset allocation decisions within these funds, we believe they often suffer the same benchmark tracking characteristics that are typical of their forebears.

We already see trustees and investment consultants placing pressure on managers to allocate to all of the permitted asset classes. As a result, these new funds rarely stray far from the central allocation of the peer group of similar funds. The manager is often not in a position to exploit their investment conviction to the fullest extent for the benefit of investors.

A pragmatic alternative

We prefer a truly diversified approach that avoids implicit benchmarking by setting an *absolute return target* and freeing proven managers to implement their best ideas to the full extent of their conviction.

Effective absolute return strategies rest upon robust and repeatable investment processes, combining dynamic allocations to traditional assets such as equities, bonds, property and treasuries, with more advanced sources of market returns accessed using derivatives. This results in a fund that actively maintains a highly diversified position, offering the possibility of positive performance regardless of individual market conditions.

This strategy frees the fund manager to roam across asset classes, with only loose constraints placed on the nature of the asset class exposure. The manager moves dynamically between asset classes, investing in those likely to generate the best return over a given period.

One way these funds can move between asset classes is to employ carefully constructed derivative positions, which helps to avoid the high costs and taxes of dealing in conventional assets and also allows the absolute return fund manager to employ asset class managers with successful track records of generating alpha, irrespective of their desire to invest in those particular asset classes, providing an additional source of returns.

Time frame is key

Historically, pension funds have had fixed exposure to the equity risk premium, which is unstable over shorter timescales. Different market participants have a natural timescale, and they only seek to profit from ideas that mature within the time-limited boundaries of their expertise. The short-term performance-measurement cycles of many scheme mandates means that opportunities have arisen for those scheme managers willing to take dynamic stances over the longer term.

Markets can be viewed by analogy: as an ecology. There are many 'organisms', e.g. investors, that make a living within the ecology. Each has evolved to compete vigorously within a chosen habitat, but tend not to compete between habitats. Just as the tree species that dominate forests change with height above sea level, different types of investors dominate different market habitats. The variable that dictates the dominant investor in a given habitat is the timescale over which the return-generating ideas mature. All classes of investor within the ecology have a natural timescale – for example hedge funds a few quarters, traditional active fund managers over six months to a year.

There are hundreds if not thousands of organisms competing on a relative basis in these short-term ecologies and as a result it becomes increasingly hard to generate returns. However, a rich and abundant habitat remains relatively unexploited in the 3-5 year absolute return horizon. Therefore, we believe that a dynamically managed absolute return fund should generally be measured over longer periods to allow the fund's managers to exploit these longer-term market horizons. Instead of investing to beat an index or benchmark in the short term, such as 3-6 months, these funds concentrate on adding absolute value for pension fund investors over a 3-5 year horizon. This period represents a relatively unexploited habitat, which sophisticated managers can exploit with rigorous research and quantitative analysis to increase returns.

Over the last few years, we have been able to exploit the flexibility afforded by longer time-frames to add value for clients. For example, last year when credit spreads became unrealistically tight, we knew that they would eventually correct, we just didn't know when. However, having the long time horizon gave us the conviction to take a short position on corporate bonds. This position did not pay anything for several months until spreads widened dramatically this summer. Likewise, when inflation expectations spiked to 3.4% last year, we were certain that this would not remain the case over the 3 year timeframe of the mandate, which gave us the confidence to go short in expected inflation and wait for it to recede, which it certainly has and will continue to do so. These are just two examples of the way that absolute returns strategies with longer performance measurement periods can exploit rich seams of returns that are closed to investors with short time horizons.

Conclusion

I began this article by asking the rhetorical question "what is the best source of returns for pension schemes?" and answered it by saying "wherever you can find them." This is an honest answer to the question as we believe a careful application of absolute return fund strategies by a team of experienced investment specialists can achieve positive returns irrespective of conditions in individual markets. It is therefore possible to roam across markets and find the returns required by pension scheme's in today's challenging environment.