

More pension funds embracing “alternative beta”

Strategies include emerging market equity, high-yield debt, public real estate securities, hedge funds

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Paul Trickett: Strategy diversifies away from the equity risk premium.

Some of Europe's largest pension funds are creating synthetic or passive exposures to alternative strategies as a way to improve risk-adjusted returns.

These “alternative beta” strategies include emerging market equity, high-yield debt, public real estate securities and hedge funds, according to interviews with pension fund executives, consultants and money managers.

“We're only in the early stages, but (alternative beta) is attracting a lot of interest at the moment,” said Paul Trickett, European head of investment consulting at Watson Wyatt Worldwide, Reigate, England. “Right now, those who are looking at this are the very big clients with a lot of resources. But in time, (alternative beta) should attract the smaller to medium-size funds interested in diversifying away from the equity risk premium.”

Among those adding alternative beta exposures include PGGM Advies BV, which manages €88 billion (\$133 billion) in pension assets for the Pensioenfondsen Zorg en Welzijn, Zeist, Netherlands, and the 445 billion Danish kroner (\$95 billion) ATP scheme, Hilleroed, Denmark.

Traditionally, pension officials have indexed widely used capitalization-weighted benchmarks — such as the Standard & Poor's 500 or the Morgan Stanley Capital International World Index — of publicly held stocks and bonds. Alternative beta is defined differently among sources, but in general, it involves using derivatives, non-traditional benchmarks such as fundamental or risk-weighted indexes, and exchange-traded funds to capture market returns from alternative strategies. These new approaches can also be applied to factor exposures, such as those used in hedge fund replication strategies. The potential advantages include diversification of beta sources, reduced costs and additional transparency, consultants said.

“It is quite difficult over the long-term — particularly if you're a large pension fund with lots of active managers — to outperform your benchmarks,” said Paul Boerboom, managing director of independent consulting firm Avida International BV, Amsterdam.

“What we're also witnessing over the past few years is that the dispersion among (active) managers in terms of returns has been very high, so that there's more of a need to actively manage your managers,” added Mr. Boerboom. “Given those factors (among others), some pension funds have decided that they might as well go passive.”

Skyrocketing alpha

While diversification is a key driver, European and U.S. consultants and managers said another factor behind the trend is the skyrocketing cost of alpha. Average investment management fees paid by pension funds globally increased by 50% in the past five years to 110 basis points in 2007 compared with 65 basis points in 2002, according to a report published by Watson Wyatt in February. External active managers were responsible for the bulk of the increase.

“Institutional investors around the world are less willing to take significant active risk in traditional large-cap equity right now,” said Kurt Winkelmann, managing director and head of the global investments strategies group at Goldman Sachs Asset Management in New York. “This doesn't mean they're taking no (active) risk, just less ... What they're doing instead is synthetically or passively gaining exposure to those (equity) asset classes. It's a way of repackaging how they take risks” in a more cost-efficient way.

One of the latest institutional investors to shift a large chunk of its portfolio to passive from active is PGGM. The reallocation, which was completed this year, involved terminating 15 external active managers running about e5 billion in assets and moving another €5 billion that was internally managed into its total beta portfolio.

“In the classical alpha mandate (which seeks to outperform a benchmark), beta will often decline as alpha also declines under certain circumstances,” said Marc Nuijten, head of alpha portfolios for PGGM. “You get hit twice ... Then it takes quite a long time to earn back the alpha.”

Mr. Nuijten pointed out that PGGM continues to strengthen its active asset management capabilities, and the €10 billion shift allowed the company to squeeze more efficiency “where we are the most successful — and that is in innovative strategies.”

ATP moves a big chunk to passive strategy

At the heart of PGGM's €63 billion beta portfolio is an initiative called the sophisticated matching approach, an alternative way of managing six index portfolios of assets with relatively high liquidity: equities; fixed income; commodities; high-yield debt; inflation-linked bonds; and emerging markets debt.

By combining all six asset classes into one giant beta portfolio, PGGM is able to be more nimble in adjusting its beta risk and exposure in a more cost efficient way, said Bob Raedecker, PGGM's head of beta portfolios. The approach uses one overall risk budget, instead of focusing on the risks of the underlying portfolios, PGGM officials explained. In addition, PGGM officials also incorporate liability-driven investing and socially responsible investment features into the beta portfolio.

For example, PGGM officials might decide to invest in U.S. high-yield bonds in a passive strategy. But a traditional indexed approach would cost the fund 60 basis points because of high securities turnover and frequent rebalancing. Implemented through a total return swap, “roughly the same exposure” could add 60 basis points to the return of the index, Mr. Raedecker said.

“Traditional indexing focuses on full replication and reducing risk, we focus on efficient replication and cost/benefit trade-offs within tight risk limits,” he said. “With integral management of the whole range (of asset categories), we can selectively choose where to take risk, pay costs and where to create flexibility in a portfolio.”

At year-end 2007, PGGM's beta portfolio accounted for about 71% of total assets. Exposure to equities was 34 percentage points while fixed income was 23 percentage points. Beta exposure to inflation-linked bonds totaled about nine percentage points and commodities, five percentage points.

The Danish ATP plan is another pension fund that is dipping into alternative beta. Henrik Gade Jepsen, chief investment officer for beta, said the fund's adoption of a targeted-return approach rather than a benchmark-driven strategy has fundamentally changed its approach to managing beta.

“If we want to invest in fixed income, for example, we would maybe look at a specific segment of the yield curve rather than a market-cap-weighted portfolio,” Mr. Jepsen said. “Then we would consider how to best implement that idea. It may be that we would invest it in cash bonds or we might do a derivative solution. We just want to be able to get the best risk-adjusted return.”

Like PGGM, ATP has also been moving more of what was traditionally actively managed assets into a passive strategy. In 2007, a significant portion of its €1 billion actively managed emerging markets fixed-income portfolio was shifted to a passive strategy managed by Citigroup Inc., New York. As a result of the style shift, Goldman Sachs Asset Management and Ashmore PLC were terminated. Mr. Jepsen decline to specify the size of the portfolio that Citigroup is managing.

Considering replication

Other pension funds — including Blue Sky Group, which manages the three main pension funds of KLM with assets of €11.6 billion, based in Amstelveen, Netherlands, and AP Fonden 7, Stockholm — are considering hedge fund replication strategies as a way to diversify beta. The £30 billion (\$60 billion) Universities Superannuation Scheme, Liverpool, England, has already made the plunge with a £200 million investment in a hedge fund replication strategy managed by the Partners Group, Baar-Zug, Switzerland.

“People are waking up to this,” said Lars Jaeger, head of alternative beta strategies at the Partners Group, which had \$800 million in assets under management as of year-end 2007. “They’re experiencing real liquidity risk, and that is working in our favor.”

So far, performance of different hedge fund replication strategies has varied widely. The Partners Group fund, for example, returned -0.9% in 2007 and 14.9% in 2006. The Goldman Sachs Absolute Return Tracker index, which is another hedge fund replication strategy, returned 12% in 2007.

Fees also vary. Partners Group charges a 1.25% management fee and 15% performance fee. Goldman Sachs charges a flat fee of 1%. The overall fee layers that hedge funds of funds charge vary, but can be about 3% for management fees and another 30% for performance fees, consultants and managers estimated.

“People are still cautious about hedge fund replication,” Mr. Trickett of Watson Wyatt said. “With a passive (equity) index, everybody knows it’s reliable. In a hedge fund replication strategy, whether returns can be delivered in a reliable way is still a big question mark.”