The Alternative Approach

How one plan sponsor is making some of these asset classes work.

BY TERRI TROY

The Halifax Regional Municipality Pension Plan (HRMPP), which has approximately $1.2 billion in assets, has been investing in alternative asset classes since 2007. Here, it provides a plan sponsor's view on tactics for approaching alternative investment strategies.

What are Alternatives?

The definition of alternative investments is not entirely clear. Some refer to them as investments that are not mainstream. In this case, alternative investments would change over time as non-mainstream investments become more mainstream. According to data from the Pension Investment Association of Canada (PIAC), non-Canadian stocks were once alternative investments in this country, accounting for 7% of the assets of Canadian pension plans in 1990, but increasing to 28% by 2009.

Others refer to alternatives as those investments that are not publicly traded. This explains why some include real estate as an alternative, even though real estate is considered a mainstream investment for Canadian pension plans. PIAC data also indicate that real estate accounted for 4% of Canadian pension plan assets in 1990, growing to 9% by 2009.

The HRMPP defines alternative investments as those not publicly traded. Besides real estate, examples are private equity, infrastructure, private debt and hedge funds.

But don't assume that all alternatives have the same characteristics. In some cases, some alternatives have similar characteristics to their publicly listed counterparts.

Public Versus Private Equity – An investor that invests in publicly traded stocks hopes that the underlying stock price increases, through growing profitability of the underlying companies and/or through dividend payouts. Correspondingly, an investor in private equity hopes to increase the value of the underlying company through board influence. This would include input into strategic plans, increasing revenues, decreasing costs, merging with another company and taking the company public via an initial public offering. An investor in publicly listed stocks is buying financial assets, while an investor in private equity is investing in operating assets. With the former, an investor is buying a stock certificate. With private equity, an investor is buying a piece or all of the operations of a company. While both are long-term assets, publicly traded equities are more volatile because their value is marked-to-market daily. Private equity valuations are conducted less frequently because of the illiquid nature of these assets.

But private equity is currently not a priority for the HRMPP because other investment strategies are likely to provide better risk-adjusted returns net of fees, and the timing of private equity payouts is less predictable than other investments.

Public Versus Private Bonds – Many publicly traded corporate bonds are unsecured. The HRMPP's attraction to private investment grade corporate bonds was primarily motivated by risk reduction. The investment reduced risk in our overall corporate bond portfolio through increased collateral behind the bonds in case of default and through reduced exposure to bonds issued by the financial service sector. When an investor has publicly traded bond mandates benchmarked to the DEX Universe Bond Index, there is a high probability that the investor is inheriting close to 14% exposure to bonds issued by financial services.

While privately issued bonds are less liquid than publicly traded ones, pension plans can mitigate illiquidity risk by investing in a bond portfolio with a four- to six-year duration. By moving a portion of the HRMPP's publicly traded corporate bonds into private bonds, it has improved

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Why Alternatives

Think this asset class doesn't have a place in your plan? Think again.

By David Mather

Most managers of alternative assets oversee a variety of alternative strategies, including private corporate debt, private equity, real estate, long/short global bonds, managed futures and hedge funds. And managers have heard just about all of the objections to these investments—most more than once.

The objectives are known as the terrible too's.

Too risky: The real risk lies in not building exposure to alternatives. The primary purpose in adding alternatives to a long-term portfolio is to reduce risk and add sources of uncorrelated return, often with a positive correlation to inflation. While the extent of correlation to traditional, long-only equities and fixed income varies by alternative strategy, the correlations are smaller. In the case of managed futures in particular, there is actually a small negative correlation to equity and fixed income.

Too soon: The time is now. The tyranny of the calendar is working against plan sponsors. Make any reasonable set of assumptions you wish about future bond market yields, the equity risk premium and inflation, and you will quickly determine that the traditional 60/40 or 50/50 mix—implemented with conventional equity and fixed income—will not deliver the required net real rate of return, never mind chip away at the deficit. The longer the wait, the deeper the hole.

Too expensive: In the past, cost was more of a concern. The downward trend over the last few years in the price of many alternative strategies is now well established and will continue. That said, don't expect fees to come down to the level of traditional, long-only equity and fixed income strategies, never mind passive options. Many alternative strategies require specialized skills that are scarce and thus available only at a premium.

Further, many strategies are capacity constrained, which dictates a higher fee than approaches without capacity constraints. However, fees and expenses increasingly are settling in at a level at which the expected excess return will compensate for the higher nominal cost.

Too illiquid: In many instances, liquidity is highly prized, overvalued and underutilized. Investing in alternatives allows plan sponsors to capture the illiquidity premium and, at the same time, facilitate higher liquidity options—to the extent truly necessary—elsewhere in the portfolio. There are means of exiting an investment early, such as a sale to other investors in a fund, a sale of a private equity interest to a secondary fund or the sale of a hedge fund position in the secondary market. These options, though, are relatively few. More important is to recognize that many strategies actually offer structural liquidity. In the case of the private corporate debt discussed in "The Alternative Approach" (page 33),

The HRMPP likes conservative real estate investments because real estate provides relatively consistent cash flows and gives some inflation protection.

its expected risk-adjusted returns net of fees primarily through improved diversification and improved security.

Infrastructure – Infrastructure is the essential asset—such as transportation, utilities, communication, social—a society requires to facilitate the orderly operation of its economy. Infrastructure assets typically have high barriers to entry, which minimizes competition. And stable or regulated cash flows, often tied to inflation, are usually a characteristic of mature assets.

Although infrastructure investments are fairly new to the Canadian pension plan industry, large plans, such as the Ontario Teachers' Pension Plan, have invested in these assets since 2001.

The HRMPP plans to increase its exposure to this asset class, assuming attractive valuations, alignment of interests and low costs. Infrastructure offers us a long-term stream of stable cash flows, in keeping with the long-term horizon of our estimated future pension obligations in conjunction with an attractive expected return net of fees.

Certain infrastructure deals can be used as a proxy for long-term corporate bonds. The HRMPP tries to match the various cash flows of our pension liabilities with that of a combination of government and corporate bonds in order to reduce interest rate risk. The combination of government and corporate bonds is dictated by the mix of government and corporate spreads used by actuaries to value current and future pension liabilities. Because of the lack of availability of long-term corporate bonds, we use infrastructure as a proxy for long-term corporate bonds. Infrastructure is not a complete proxy because infrastructure assets also include an equity component.

To date, we have co-invested alongside other pension plans. We prefer co-investing with a large experienced plan that wishes to syndicate a portion of its newly acquired infrastructure investment. But, to do this effectively, we have chosen to pool our investments with other like-minded plans in order to get to the minimum size for an investment in the syndication. The benefits of doing so include sharing of legal and due diligence costs, improved due diligence and alignment of interests. Ongoing costs are typically significantly lower than investing in a third-party pooled fund since the profit motive is eliminated.

Instead of investing in a blind pool and leaving it up to the manager to pick the investments, the investor can:

- invest alongside the larger plan that has already conducted thorough due diligence on the asset and usually keeps 90%-plus of the investment;
- invest alongside other smaller plans through a consortium; or
- invest in only certain deals that it deems attractive.

Cost savings are extremely significant. A typical third-party infrastructure fund charges a base fee of 1.25%, plus a 20% performance fee. This equates to a 1.65% flat fee, assuming a 10% rate of return and an 8% hurdle rate [1.25% + 20% (10% - 8%)]. If the infrastructure investment is expected to earn 10% gross of fees, this would equate to an 8.35% net of fee return before operating expenses are deducted. Co-investing, on the other hand, allows the investor to earn a net of fee return that is closer to the gross return, which, in this example, is 10%.

Another benefit of investing alongside pension plans is that the parties are likely to have similar time horizons (i.e., 30-plus years). Most third-party infrastructure funds have terms of 10 to 12 years. A shorter time horizon may appeal to some pension plans that want a predetermined arbitrary exit date. But usually, a 10-year time horizon is present in third-party infrastructure funds as a mechanism for the investment manager to recoup its performance fees within a reasonable time period.

Real Estate – A relatively common investment for Canadian plans, real estate comes in a variety of types: retail, industrial facilities, residential and office space.

Profitability of a real estate investment may be tied to factors such as consumer spending and industrial production (with retail and industrial facilities) or the level of employment and corporate spending (with residential or office facilities). Plans looking to invest in real estate have the option to invest indirectly using a publicly listed security such as a real estate investment trust, or directly in real estate assets as part of a group or individually.

The HRMPP likes conservative real estate investments because real estate is long term in nature, provides relatively consistent cash flows, has the potential for capital gains and gives some inflation protection. These investments include mature properties where most of the expected return comes from rental income. Full or partial inflation protection associated with real estate is a major benefit to pension plans, especially those providing indexation of benefits to pensioners and/or career average DB plans.

Hedge Funds – The CFA Institute describes a hedge fund as "an investment vehicle designed to manage assets according to any of several strategies. The investment strategy often employs arbitrage trading and significant financial leverage, while the compensation arrangement for the manager typically specifies considerable profit participation." PIAC data show that Canadian pension plans in aggregate don't have significant exposure to hedge funds.

Hedge funds are not a priority for the HRMPP because they lack transparency, have relatively high fees and may typically require a lock-up for investments that are not typically long-life assets.

Other Considerations

A chief investment officer or investment committee needs to understand what percentage of the pension plan's assets can be in illiquid assets without triggering the need to liquidate other publicly traded assets at inopportune times—for example, the 2008 credit crisis. Considerations are whether the pension plan is net cash flow positive or

not only do the loans provide monthly payments, often those payments are a blend of principal and interest on self-amortizing loans, which means that investors begin getting their capital back, with interest, immediately. You may not be able to sell that power plant in which you have an interest, but you can be highly confident that it will deliver a steady stream of stable, predictable cash flow with a positive ratchet to inflation.

Too complicated: To be sure, some fiendishly complicated strategies have been concocted. But many of these disappeared in the credit meltdown and are unlikely to return. Some of the most attractive alternative investments—such as real estate, private debt and infrastructure—are arguably easier to comprehend than some of the more arcane strategies applied to public fixed income and public equity. The knowledge base is expanding quickly in the plan sponsor community, consultants are now better able to advise investors, and managers can provide information and understanding without obligation.

Too small: Today, no plan is too small. Strategies that once were accessible only on a direct basis by the largest funds—with in-house expertise—are now available through a wide range of options, including pooled funds, funds of funds and even exchange-traded funds. "The Alternative Approach" shows how plans can collaborate to take advantage of the experience and scale of the larger funds to participate in large direct transactions. The knowledge required is now widely available and the means of implementation many and varied.

Clearly, plan sponsors are increasingly adopting alternatives and understand that they must make meaningful allocations to realize the benefit. Mercer's *Canadian Asset Allocation* study found that 25.3% of the funds surveyed were investing in alternatives; the average allocation was 14.9%. More plan sponsors will join them. **BC**

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negative, and understanding how liquid the pension plan's other assets would be when assets, other than Government of Canada bonds, may not be easily liquidated.

Currency risk comes into play for any foreign investment, whether publicly traded or privately held. The HRMPP's policy is to hedge all foreign alternative investments because adverse currency movements could quickly wipe out the expected stable returns from the alternative portfolio in any one year.

The above are practical considerations from the HRMPP's perspective. Other plans will think differently about alternatives, because of different investment beliefs, risk tolerance levels and resources. But if you are considering adding alternatives to your investment lineup, gather as much information on alternatives and get as many experiences from other plans as you can. **BC**

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- How to take advantage of the latest drug plan design trends
- Understanding cost drivers and utilization

FEATURED SPEAKERS

John G. Abbott, Chief Executive Officer, Health Council of Canada
Dr. Alan Cassels, Drug Policy Researcher, University of Victoria
Dr. Jake J. Thiessen, Founding Director, School of Pharmacy, University of Waterloo

For agenda information and to register, go to:
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