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Pension plans big and small are moving into the alternatives space *By Scot Blythe*

The rebuild of Montreal's Champlain Bridge—reportedly the busiest crossing in Canada but weakening with age—may be brought to you by a pension fund. In fact, it's not hard to find stories about a Canadian fund taking a stake in a British airport or an Australian toll road. But what's behind the bustle?

David Rogers, a former senior vice-president at OMERS and now a partner of Caledon Capital Management in Toronto, which acts as a consultant for smaller pension plans, explains that "the volatility in the public markets...is making people very nervous. The fixed income returns—whether it's the U.S. government or the Canadian government—they're quite low....So I'm a pension fund today, and I have an actuarial requirement to pay pensions, and I say, 'My goodness, I don't think I'm going to get there with just public equity and fixed income. What are the other asset classes that might allow me to add additional returns to the mix?'"

Shifting Buckets

According to data compiled by the Pension Investment Association of Canada, in 2000, the average investment mix for a pension fund included a 7.5% allocation to alternatives—almost entirely real estate—while the bulk of investments were allocated to Canadian bonds (29.5%) and Canadian equities (27.9%). A decade later, the average allocation in bonds has retreated slightly, to 26.2% (thanks, in part, to a higher weighting in real return bonds), while the Canadian equity component has dropped sharply, to 16%.

That reflects higher allocations to global equities—particularly emerging market equities—but it also reflects a pullback from equities on the whole. Alternatives are now 25% of the total, with real estate exposure at 8.86%, private equity at 7.24% and infrastructure at 4.15%. (Hedge funds are also in the mix but represent less than 2% of the average allocation.)

Of course, some of the bigger plans have much higher allocations to private equity—think of the Ontario Teachers' Pension Plan's (Teachers') participation in Maple Leaf Sports and Entertainment—as well as to real estate and infrastructure.

All of this points to three questions:

1. **What** can these asset classes deliver to a traditional stock-and-bond portfolio?
2. **What** are the current market conditions?
3. **How** can smaller pension plans gain access to these asset classes?

"Pension funds have a certain portion of the population that is retirees," explains David Mather, executive vice-president of Integrated Asset Management in Toronto. "They typically receive monthly pension cheques, so there's a keen interest in regular cash flow. But it's [also] in the nature of many types of real estate and some types of infrastructure that there's a great deal of stability and predictability to the cash flow. That's valuable in and of itself."

In addition, real estate and infrastructure are regarded as inflation-sensitive assets. "That's very important for a pension fund because [of] the benefit of some kind of ratchet to inflation," says Mather. "So a pension fund has a keen interest in any kind of an asset that has a positive correlation to inflation."

Adds Rogers, "When you're investing in real estate and infrastructure, you're looking to invest in core or core-plus type assets that are mature and have a history of cash flow. In the case of real estate, it would be lease payments because you're fully leased. In the case of infrastructure, it would be dividend payments, whether it's from a P3 [public-private partnership] project or a bridge or a toll road that's mature."

Yield is an important component, he explains. "[Pension investors] are hoping to generate a 10% to 14% return, depending on the risk of the asset, and probably half is going to be from ongoing yield and half from capital appreciation. You're not seeing the volatility because either you have long-term contracts with these assets, with a group that's seeking your product, or you're a regulated asset—a utility or some type of power generation plant that's getting a return in the 10% to 12% range."

Private Equity Challenges

Although, like real estate and infrastructure, private equity has a low correlation to equity markets, it doesn't have a regular coupon or interest payment. It's more about alpha: achieving a return that is better than that from public stocks. "You see people characterizing their expectations in different ways. In broad terms, I think investors would say that they're looking for 2% to 4% over public markets," says Mather.

That makes private equity a less-likely component in the portfolio, at least for smaller pension plans. "The plan's main focus is to look for private assets that have long-term stable cash flows," says Terri Troy, CEO of the Halifax Regional Municipality (HRM) Pension Plan. "While core infrastructure and core real estate fit this criteria, private equity does not because returns are 'lumpy.' There are no returns or low returns at the front end (coupled with high costs) and, hopefully, a large payout at exit via a sale to a strategic buyer or an initial public offering. Private equity would be considered part of the growth portfolio, complementing public equity." That said, HRM has made one private equity investment: a co-investment alongside other institutional investors.

It's important to note that private equity, like real estate, has a number of sectors. There's venture capital, which is devoted primarily to start-up technology and biotech companies. There's also mezzanine debt, in which investors provide junior debt, normally with an equity kicker to companies that have exhausted their lines of credit and are unwilling to go to public markets with junk bond yields—non-investment grade bonds (because they have a higher probability of default) that yield 600 or more basis points above high-quality or "A"-rated corporates. Finally, there are leveraged buyouts (LBOs).

LBOs attracted much of the attention in the mid-2000s. With an LBO fund, the idea is take a company private, turn it around and then put it up for sale. However, many institutional investors prefer to take a company private and keep it for its cash flow—for example, Teachers' with Maple Leaf Sports and Entertainment or OMERS with the GolfTown Income Fund. So it's not necessarily a buy-and-flip strategy; it could also be buy and hold.

That's a feature that is attractive to pension plans. Says Troy: "Our plan wants to hold core infrastructure assets we like for a long time, unless there is a compelling reason to sell (e.g., a buyer is willing to pay a high price for the assets).

So I don't think anyone would go into private equity unless they're looking for 15%-plus returns. Canadian core real estate assets, which are currently at peak valuations, are expected to return 6% to 8%. Core infrastructure is expected to return approximately 10%. The appeal of private investments relative to public markets is the fact that these assets are sheltered from the extreme day-to-day movements in public markets. My portfolio of private assets is not going to experience the same day-to-day volatility as the public equity market portfolio."

Private investments are certainly appealing, but this raises two issues: price and access. It's not hard to see that private equity is in the doldrums. Many of the big LBO firms have taken haircuts on headline-grabbing acquisitions. They bought at the top of the cycle, with cheap financing. Now it's proving harder to turn those companies around—and they have to refinance their debt.

In most instances, private equity buyers have signed on to funds. The bigger pension plans may also be co-investors in particular deals. For the funds, there's a further drag: funds usually have a lifecycle of five to 10 years, and capital is raised and deployed, but not all at once. Instead, investors are on the hook for capital calls; as the initial capital is invested, there may be follow-on investments in the next two or three years.

With private equity, says Mather, "my sense is that, for several different reasons, the bloom has come off that particular rose. I think there's been some performance anxiety....But one of the things that I think people are increasingly sensitive about in private equity is that there's a huge dispersion of returns. For example, in the 2008 vintage year, the spread between the midpoint return and the top quartile is more than 40%. What that means is, there's a high dependency on manager selection and manager skill. That's one issue."

Saddled with poor performance and facing the prospect of a capital call, many investors are balking. "They're asking for more capital to prop up failing investments, and people don't like that very much," says Mather. More than that, they need liquidity, so they are selling their interests into a nascent secondary market. "What that means is that there are people who are saying, 'You know what? I'm out of here. I've had enough; I'm not hanging around for any more capital calls. I've been disappointed with the returns.' So they're selling their interest to another investor—or, more commonly, to a secondary fund," he says.

Alternatives are now 25% of the average pension fund investment mix

That creates bargains for investors who have enough time to commit to the space. Explains Andrew Willis, a spokesperson for Brookfield Asset Management in Toronto, "The private equity market right now is relatively robust, because credit markets are reasonably good. Where everything sort of shut down in '08, because there wasn't leverage, I think there is now the ability to borrow from banks. And up until quite recently, the high-yield market was supportive, so that helped with all of the financial aspects of private equity transactions—although you're not seeing anything anywhere near as large [as what] you saw in the '07 period."

Real Estate and Infrastructure Opportunities

With real estate and infrastructure, it's different. Valuations are not stretched, but they're not cheap, as more investors are attracted to the returns profile. With infrastructure, Mather reports, "there continues to be a very keen interest, and a lot of money has come into that space in a relatively short period of time. As a consequence, there has been some compression of returns, and return compression suggests that the valuations are getting a little higher. I don't think there's anything extreme there, but I think there's a sense that many infrastructure assets are fully priced right now."

Adds Eric Bonner, senior vice-president with Brookfield, "The infrastructure market is a little bit more mixed in that there are always large opportunities that are being put on the market, and they typically get put out in broad auctions. In those kinds of circumstances, because there is a lot of capital looking for investments in infrastructure space, it tends to attract a lot of buyers—so those types of assets tend to get bid up. Valuations are typically quite high, and returns are relatively low."

Still, he says, more opportunities are coming to market. "There are pockets where there are good opportunities. And there are also situations where you've got, let's say, developers that have developed infrastructure, whether it be toll roads or whether it be ports or maybe...on the renewable power side, where they need to sell to take their capital and put it into the next development. There are opportunities coming out of developers that are looking to sell off some of their assets. And then, of course, the sovereign crisis in Europe is also freeing up opportunities through managers based in Europe who have portfolios that include assets that they may not want to hold anymore because they need to bring capital home to shore up their balance sheets."

Real estate is a bit more complex because it, too, involves different sectors: core (namely, rental properties in the retail space, such as shopping malls); office, industrial and multi-residential sectors (apartments, hotels and long-term care facilities); value-added (which comprises fixer-uppers); and opportunistic sectors (such as greenfield developments).

Still, "real estate has come off the bottom," Mather notes. "The all-property return for the year ending June 30 was 13.5%, and of that 13.5%, 6.5% came from income and 6.5% from capital growth."

Getting in the Game

Large pension plans—such as Teachers' and OMERS—have in-house teams to evaluate the opportunities and the cash to make direct investments. This is, by far, the cheapest route; in fact, OMERS' overall cost of investment management is about 10 basis points. But few funds have the scale of expertise and inflows to make direct investments, which often start at $100 million.

However, there are options for smaller pension funds. There are directly traded infrastructure and property companies on the stock exchanges. There are REITs (real estate investment trusts). There are closed-end funds, in which investors are locked in until the fund matures. To a greater or lesser degree, all will bear some correlation to stock market movements.

On the private side—where the volatility is less but so is the liquidity, unless there's a thriving secondary market—there are funds of funds, which are expensive because they add two layers of management fees. There are also fund investments, generally with a 10-year maturity, whereby a pension plan places money with a private manager who then looks for deals.

One area that Troy finds promising is co-investing alongside larger institutional investors. "To participate in co-investment opportunities, you have to put the word out that you're willing and able to do these types of deals, because the lead investor needs to know that they can rely on you to close. I've been lucky because I've been able to do two infrastructure co-investment deals alongside one of the largest pension plans in the world and eight other pension plans. The most recent deal was the 407 highway—that's one that we all want to hold for a very long time. With infrastructure deals, you have political risk. However, the 407 contract has already been tested in the court when the Government of Ontario contested some of the terms. The contract is solid. This is reassuring."

There are also open-ended, but private, real estate funds that operate much like mutual or pooled funds, with continuous redemption. "The advantage of open-ended funds is that you have immediate access to the assets, and you have the liquidity to exit from the pool, albeit sometimes with a penalty. This avoids the blind pool risk associated with many closed-end pooled funds. With a closed end, you're committing capital, but then that manager has to go out and buy. So you may not have exposure for years until they actually go out and do the deals. Another way to minimize blind poor risk is to invest in closed-end funds via the secondary market, where a seller wants to sell its position in a fully or partially invested closed-end fund. The only liquidity option prior to realization of assets is through a transfer of ownership to a willing buyer," explains Troy.

Co-investment may seem ideal, but it still has its challenges, adds Asif Hussain, a partner with Caledon Capital Management. "I think it requires three things. It requires size, because with infrastructure in general, some of the transactions can be quite large, especially in Europe and North America. The second thing is that it requires the ability to move fast, because often, a transaction timeline can be quite short. Even at the last minute, you have to be able to regroup and make a decision based on that new structure." Finally, he says, plans have to be able to bear the costs of lawyers, consultants and advisors—whether or not a deal goes through.

Against highly volatile, disappointing public market returns, private market investments are increasingly attractive for plan sponsors. They are becoming more accessible, too. They require due diligence and an investment infrastructure to get the right deals at the right price—but the rewards are in sight. BC

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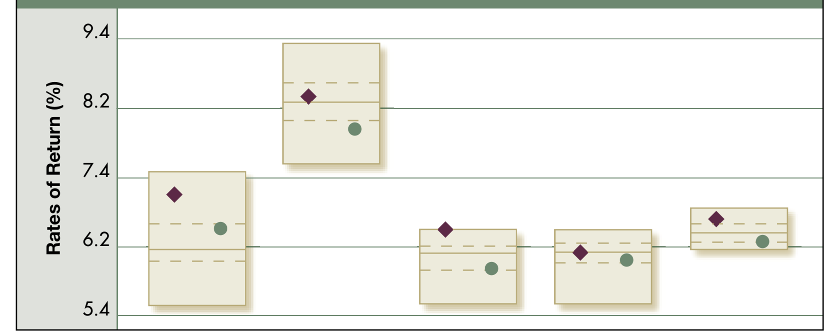
Comparison with the Pooled – Canadian Fixed Income (PFS) universe (Percentile Ranking)
Return in $C (before fees) over 1 yr, 3 yrs, 5 yrs, 7 yrs, 10 yrs ending September 2011



	1 Year (%pa)	3 Years (%pa)	5 Years (%pa)	7 Years (%pa)	10 Years (%pa)
LINCLUDEN ◆	7.15 (9)	8.56 (9)	6.63 (5)	6.31 (46)	6.78 (20)
DEXU ●	6.66 (27)	8.10 (31)	6.08 (67)	6.20 (68)	6.48 (62)
Median	6.34	8.48	6.28	6.30	6.58

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