Thinking BIG

How can smaller pension plans access the asset classes normally reserved for the top players?

By Martha Porado

For some investors, tradition isn’t cutting it anymore. Rock-bottom interest rates are squeezing fixed-income returns, and the need to diversify through sturdy, lower-risk assets is apparent. While low volatility in equity markets is comforting, how long will it last?

“We don’t know when but we’re pretty sure the equity market will correct, maybe severely,” says Yvan Breton, head of fiduciary management for Canada at Mercer.

More sophisticated assets, like infrastructure, private equity, private debt, credit and hedge funds, have investors’ attention. But barriers often keep smaller pension funds out of those types of investments. Given the pressure to seek alternative options, what can smaller players do to think like their larger counterparts?

Every fund needs to mitigate risk, but finding that stability while maintaining decent returns isn’t easy, says Breton. “De-risking a plan doesn’t necessarily mean selling equities and buying more fixed income. Nobody wants to buy more fixed income these days.”

While alternative assets can provide good solutions, plans need to remember that “a hedge fund is very different than private equity,” he adds. “So a solution might be good for one investor and not for another one.”

The process of learning about new assets can also be daunting, says Dany Lemay, head of delegated solutions for Canada at Willis Towers Watson. Still, he acknowledges the need to consider them. “In some cases, there’s not really a desire but oftentimes a need, a true need, because again, they need to manage a reasonable level of return in the long run.”

The traditional roadblocks

There are many types of allocations that require arduous administrative processes to make them work, says Breton. Closed-end funds, for example, are an area where a lack of resources, both human and financial, could make investing impractical, he says. Frequently used by larger players, the funds often require capital calls over a period of years. “You need someone that will be responsible to make those funds available when the manager calls that money. There are severe penalties. So from an operations point of view, it’s difficult for smaller plans,” he says, adding that since building the full position could take years, smaller plans could experience liquidity problems if they tie up significant amounts of capital in a long-term strategy.

“De-risking a plan doesn’t necessarily mean selling equities and buying more fixed income,” adds Breton. “You need someone that will be responsible to make those funds available when the manager calls that money. There are severe penalties. So from an operations point of view, it’s difficult for smaller plans.”

Overcoming the barriers

The roadblocks have lessened over time, however. “Compared to where it was five years ago, we don’t feel that these hurdles are necessarily an excuse anymore, although it may be still relevant to some smaller players,” says Lemay. “Among the ongoing challenges is the ability to build an in-house team. ‘For funds of our size, we have two choices. We can spend a lot of money and build up a lot of internal staff to do it in-house or we can go to a third-party manager,’ says Stefan Cowell, chief executive officer of the $7.9-billion Nova Scotia Health Employees’ Pension Plan. “For a fund like Cowell’s, which currently has 90,000 active members and 10,500 pensioners, it’s a bit of a challenge in Halifax to develop the type of talent pool you might require to be in that field,” he says.”

For plans without large in-house teams, outsourcing expertise is one option to access more sophisticated investments. “You see more and more . . . the outsourcing of the investment management of the pool of assets. Pooling the assets with other investors through an outsourced chief investment officer makes sense for so many pension plans,” says Breton. “Funds, however, will still need to keep abreast of their allocations, even if they seek outside help, says Colin Ripsman, vice-president and portfolio manager for institutional client services at Foyston.
Gordon & Payne Inc. “I don’t think, at the end of the day, that you can fully get away from your fiduciary responsibility. You really have to understand what you’re buying,” he says.

Even with some plans’ monetary limitations, certain investment options are readily available. It’s simply a matter of doing the research. “Realistically, any of us in this tier and below could easily get access to any third-party manager platform. It’s just a matter of spending the time to make sure it has the right risk-return profile,” says Cowell.

One option is to look at open-end funds. Unlike closed-end funds — which typically involve investments in areas like infrastructure, real estate and private equity and focus on improving the asset’s value over a period of time — they don’t require capital calls, says Breton. Open-end funds invest in existing, ongoing projects that generate income, which makes them much more appropriate for smaller plans with higher liquidity needs, says Breton.

Funds of funds are another way to access more complex holdings, such as hedge funds, says Lemay. While they’re a relatively common tool, the layered structure can lead to higher fees, he notes. “I think what we’ve seen over the last several decades are people having concerns over the costliness of that sort of thing, paying fees on top of fees and starting to say, ‘Is this actually effective?’”

investor can get dispirited at the outset of doing so can help prevent snowballing fees.

Dipping a toe
Choosing where to begin is crucial for smaller plans, as they usually don’t have the funds to participate in more than one or two complex asset classes, says Breton.

“You need to make sure that you allocate at least 10 per cent of your portfolio just to say, ‘You’ll have an impact from a risk reduction or a diversification point of view,’” he says.

So which sectors are suitable for those plans just getting started?

“I would say credit is the one area where smaller plans could access it, either through your existing fixed-income manager or through a specialist manager,” says Ripsman.

Lemay says some clients are keen to discuss credit but he notes they may need to look abroad to find suitable opportun-

ities. “The Canadian fixed-income and credit spaces are quite limited and it’s a tiny percentage of the broader credit market globally. So there has been an interest to expand outside Canada to better diversify and seek additional sources of credit returns,” he says. Credit assets from outside Canada, such as high-yield bonds, emerging market debt, bank loans and direct lending, are all potentially of interest, he says.

Hedge funds are another possibility. “I’ve had a bunch of hedge funds, mainly because of the fear of correction for the equity market,” says Breton. “Those yields for hedge funds might be a good compromise between fixed income and equity.”

As for infrastructure, investing in a fund in that area can open doors to further opportunities for smaller plans. “You tend to have a longer-term relationship with the fund, so you can do more co-investment opportunities,” says Cowell.

Investing as a partner alongside a fund to own a stake in a real asset can be a cheaper option a smaller plan could really work with, he says. “The more direct the link to the physical asset, the lower the fees, he adds. “Our initial allocations would be to [an infrastructure] fund, but with that, we would then look for co-investment rights.”

However, getting into real assets requires a big commitment, he notes. “You do have to make some conscious decisions about how to access the illiquid, more sophisticated asset classes.”

When looking at private equity or debt, availability isn’t a problem, says Cowell. But the plan, he notes, should have a firm grasp of those assets’ purpose in the portfolio. “You have to have the right understanding, and your board or your investment committee needs to understand the accretive value of these strategies,” says Cowell, adding that gaining that in-depth knowledge can mean a lot of work at the outset.

When it comes to defined contribution pension plans, gaining access to complex alternative assets poses a different set of problems. When plan members have control over their invest-

ment options, giving them the choice to include assets they aren’t familiar with is risky, says Luis Ramirez, a principal at Mercer.

“If of course, you don’t want to have those things available as a standalone option for a DC plan, because you can’t control how members would be using those investment options,” he says.

Exposure to alternative assets, however, isn’t out of the question. “The majority of target-date funds do have exposure to these instruments,” says Ramirez. “So plan members are getting that exposure, having more diversification and allocations to those alternative investments, but without even knowing it because most don’t understand what’s in their target-date funds to begin with.”

A will and a way
As new ways of gaining access to those asset classes emerge, the appetite for smaller funds is growing, says Lemay. “I would say desire increased quite significantly and, as a result, that’s why we’ve seen more and more, not only the large ones but even the smaller plans, starting to invest in those asset classes.”

And despite the challenges, smaller plans are starting to get a handle on how to approach more complicated strategies. Lemay offers an example: “A pension fund I started working for a few years ago had made commitments to some private equity funds of funds about 20 years ago. ... They ended up realizing they were overly diversified, so the experience wasn’t that positive because they had to pay a vast amount of fees and [were] not actually getting the diversification they thought they were getting.”

“They then adjusted their strategy along the way and said, ‘Well, we’ll work with the proper providers and make sure we can build a portfolio of our own and really look more holistically towards this bucket of real assets and private equity, bundled together.’” They went gradually, moving from 1 per cent to five per cent, and they’re looking to go to 10 per cent in real assets.”

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