Attentive to Alternatives

Alternative Investments by Plan Sponsors are Becoming Mainstream in Canada

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Plan sponsors face a challenging investment environment and many are turning to alternatives, which come with their own unique challenges and opportunities. Given the need by pension funds for returns, diversification, and risk management, alternatives are becoming a more mainstream investment choice as they look to generate ROI.

SUSTAINED LOW-INTEREST RATE ENVIRONMENT

There are an array of challenges in today's complex investment environment, including sustained low-interest rates in Canada and globally, rising price to earnings ratio (P/E) multiples, and economic headwinds from ongoing investment market volatility. As a result, many plan sponsors looking to add more diversity to stock and bond-dominated portfolios are increasingly considering alternatives. Plan administrators are setting asset allocation targets to include such diverse asset classes as over-the-counter (OTC) derivatives, real estate, swaps, private equity, infrastructure and hedging strategies, spanning both regional and global jurisdictions. According to PricewaterhouseCoopers,[1] fund performance, investment strategy and managerial track record rank among the leading investment criteria for those considering alternative opportunities. While the desire for increased yield ranks high, so does the stability that can possibly be attained through hedging and other non-traditional approaches.
Plan sponsors around the world face pressures such as meeting necessary funding ratios and the search for returns. In this market environment, the alternatives space is trending up. According to Canadian Institutional Investment Network data,[2] Canadian plans' alternative assets have grown to $341.9 billion in 2014 from $186.7 billion in 2010. In terms of asset class rankings, real estate equity represents the highest allocation and the paper reports that real estate equity reached $139.6 billion in 2014, which was up by 14.9 per cent since 2013. Infrastructure saw the largest five-year growth at 112.8 per cent and the paper notes it reached $76.8 billion in 2014. It is also mentioned that commodities grew the most yet in a one year period at 42.8 per cent from 2013 to 2014, reaching $18.4 billion in 2014. The chart on page two shows overall growth of pension holdings in alternatives from 2010 to 2014.

INDUSTRY TRENDS FOR ALTERNATIVES IN CANADA

Those seeking straight-up portfolio diversification have a number of non-correlated options to choose from, including global macro funds, as well as managed futures. The Alternative Investment Management Association (AIMA)[3] sees some investors abandoning stocks altogether in favour of "substitute" allocations such as long/short equity or credit strategies, as well as fixed income or convertible arbitrage.

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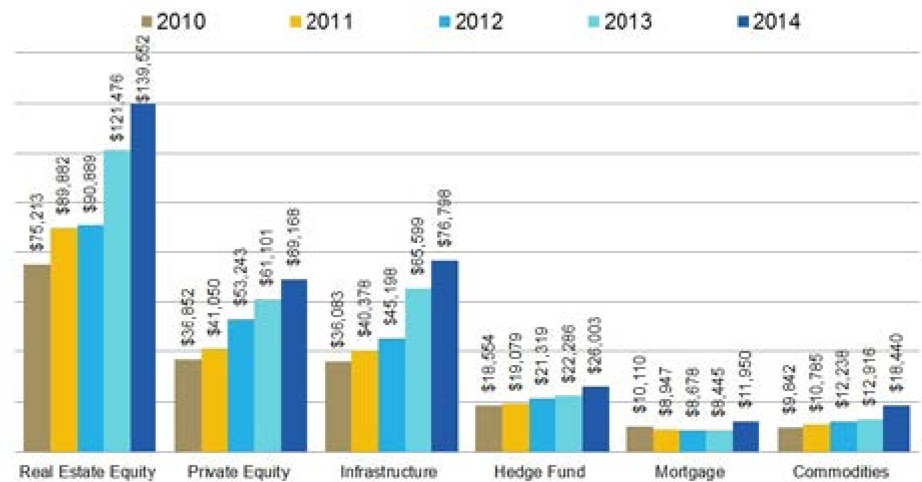
YEAR-OVER-YEAR ALLOCATION TO ALTERNATIVES (IN MILLIONS) BY CANADIAN PENSION PLANS



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Nonetheless, there is increasing investment interest in the alternatives space. According to PwC estimates,[4] it is expected that "traditional active management will grow at a less rapid pace than passive and alternative strategies, and the overall proportion of actively managed traditional assets under management will shrink." Along the way, plan sponsors may seek providers with the flexibility to meet their specific needs and financial services firms could become more agile in their approach to alternative strategies.

THE ALTERNATIVE EDGE

Recent data reflects the trend of alternatives becoming mainstream. In its Global Hedge Fund Distribution Survey, PwC, in conjunction with AIMA, found that some 44 per cent of global hedge fund managers anticipate introducing a new fund product by the end of 2016. In the survey, more than six in 10 noted an increase in hedge fund AUM; over 80 per cent of those offering liquid-alternatives funds expect further growth for these strategies going forward.

Meanwhile, a report on Canada's ten largest public-sector pension funds by Boston Consulting Group (BCG)[5] underscores the momentum toward alternative diversification. According to BCG's survey, about one third of the funds' combined $1.1 trillion in AUM is currently invested in alternative classes that include both domestic and global private equity as well as real estate and infrastructure targets. By contrast, smaller Canadian plans currently have less than 11 per cent exposure to alternatives.

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There may be a decline in actively managed assets under management through the end of the decade, which could coincide with an increase in both alternative and passive fund strategies, with alternatives increasing by nine per cent through the period. Along the way, plan sponsors may seek providers with the flexibility to meet their specific needs and financial services firms could become more agile in their approach to alternative strategies.

As noted in the Canadian Institutional Investment Network's 2015 report, real estate remains one of the top segments for Canadian pension managers. The types of real estate investments can broadly vary. Multi-family real estate investment trusts (REITs) may provide a regular income stream, while also serving as an inflationary hedge. Mortgage REITs, which invest in mortgages and mortgage-related interests, have been seen to attract significant capital. This trend also extends to equity REITs and REIT IPOs, which are designed to profit from start-up REIT activity. Additionally, the securitization of certain foreign real estate assets has helped some regional managers expand their investment horizons. In addition to real estate investments, many large Canadian plan sponsors have the scale, expertise and experience to undertake substantial direct investment activities in the real estate space. Investing directly provides the largest plans with lower costs and greater control. As noted in the 2015 Canadian Institutional Investment Network report, almost all pension plans, regardless of size, have an allocation to real estate, whether it is directly into a building or a REIT or other type of investment in an equity position. It is important to note that not all types of real estate have the same measures or risks, so plan sponsors would be well served by efforts to understand what each individual component means to a portfolio. Analysis is more accurate when using a regional-level proxy rather than a broad global real estate index. Furthermore, the proxy process may be enhanced by factoring in the respective various classes of real estate (e.g. office, residential rental building, shopping mall).

Canada has been a leader in direct infrastructure investments for more than a decade; at present infrastructure accounts for some five per cent of all Canadian pension allocations. Much of this activity has been confined to larger pension plans, who can be seen as the early adopters of infrastructure-based strategies. Additionally, nearly half of Canada's infrastructure investments are made directly, according to global research firm Preqin,[6] resulting in lower overall costs as well as greater control.

STAYING THE COURSE

Currently ranked fifth in size[7] globally, the $1.7 trillion[8] Canadian pension market continues to adopt alternative investment strategies as well as supportive technologies in an effort to stay ahead of the funding curve. Alternative strategies can be seen as playing a central role in pension plan alpha generation efforts. With interest rates remaining low and debt and equity market correlation on the rise, plan sponsors are expected to continue to increase their allocation into the likes of infrastructure, real estate, private equity, hedge funds and other alternatives. While improved ROI remains a priority goal for plan sponsors, meeting challenges such as elevated risk, transparency, and governance standards has been no less important. For alternative investments, plan sponsors need complex analysis in order to get certainty over their risk and understand the impact on their portfolios. It is important, therefore, for plan sponsors and asset managers to assess and manage their plan's risk effectively; consider liquidity options, and assess how they can improve their ease of trade execution to achieve their targeted returns.

As markets and stakeholder expectations evolve, plan sponsors and asset managers alike can expect an increasing onus for awareness of risk considerations, including being responsible for understanding new strategies, asset class complexity and their own risk profile. There are methodologies that can help measure and manage portfolio risk, using sophisticated analysis models to simulate macro "what-ifs" and other potential situations in the making. Helping plan sponsors become smarter, more efficient assessors of risk will likely continue to be a strong selling point for third-party solutions providers in the years ahead.

PRACTICAL CONSIDERATIONS FOR RISK ANALYSIS

Plan sponsors require an understanding of how risk operates across all investments within an entire investment program. As a result, enterprise risk analysis such as stress testing and scenario analysis are increasingly popular with plan sponsors in contrast to the previous single-measure assessments. The issue that many plan sponsors are facing is how to incorporate alternative investments (hedge funds, private equity, and real estate) into this type of risk analysis. Plan sponsors looking to learn more about risk management can refer to BNY Mellon's application paper, Considering the Alternatives: A Practical Look at Enterprise Risk Analysis and Alternative Investments.

DATA MANAGEMENT AND RISK CONSIDERATIONS

Different approaches to data management can lead to different potential conclusions about the risks within an investment portfolio. Some thoughts to consider in this area are:

- Having a consistent approach across the most granular detail available to evaluate investment risks. Obtaining position-level information for all asset classes is generally considered a good practice.
- Considering hedge fund structures that can provide position-level transparency, liquidity and control. Hedge fund managed accounts and liquid alternative funds are increasingly popular structures that offer such features.
- Using a single point of contact to pull together a pension plan's total investment data supports a more uniform approach in calculating enterprise-wide risk and exposure, whereas data across multiple platforms adds to the complexity and likelihood of errors.

Evaluating volatility-based measures like Value-at-Risk (VaR) is just one element of a broader risk management framework that considers other factors such as exposure. Consider augmenting your current process with VaR for portfolios relative to the total composite, as a benchmark, or over time, rather than as an absolute value.

According to BNY Mellon's paper, Building for the Future: How Alternative Investment Managers are Rising to the Demographic Challenge, the need for transparency, driven by clients and regulators, is prompting a growing number of managers to consider outsourcing certain functions. Overall, two-thirds of fund managers across all asset classes feel regulation might lead to outsourcing in the future. Cost was the most commonly stated reason to outsource, in addition to having access to enriched data and analytics from an outsourcing provider and access to the expertise of external staff.

As a large number of drivers prompt plan sponsors to contemplate investing in alternatives, there is a greater need for transparency in order to understand the risks and complexities of this asset class. Working with an asset servicing provider can offer plan sponsors the benefits of a rigorous and uniform process to help monitor and manage risk across your portfolio, so plan sponsors can be well positioned to achieve greater clarity and control when tapping into opportunities in the alternatives space.

Notes:

1. PwC Press Release: Almost 50% of Hedge Fund Firms Plan to Launch a New Hedge Fund by the end of 2016
2. Chronicle: An Overview of Pension Plans in Canada 2015 by the Canadian Institutional Investment Network, Sponsored by Invesco
3. AIMA/CAIA Report - Portfolio Transformers: Examining the Role of Hedge Funds as Substitutes and Diversifiers in an Investor Portfolio
4. PwC: Asset Management 2020 A Brave New World
5. The Boston Consulting Group (BCG) Study: Measuring Impact of Canadian Pension Funds
6. Prequin Infrastructure Investment in Canada Report
7. Willis Towers Watson Article: Top Pension Fund Assets Almost Double in Ten Years
8. At the end of 2014, Canada's top 1000 pension plans were managing $1.7 trillion in assets: Canadian Institutional Investment Network's 2015 report

Questions

To learn more about the solutions and support available from CIBC Mellon and BNY Mellon for plan sponsors engaging with alternatives, contact your CIBC Mellon Relationship Executive or Account Manager, or call us at 416-643-5000.

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