



# Unlearning lessons from the past

**With traditional fixed income instruments no longer meeting pension liabilities, investors are journeying along the risk curve and investigating alternative liability matching sources to complement their equity exposures.**

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Pension fund trustees used to be transfixed by one end of the risk curve. They typically played it safe and only invested in government-issued or investment grade bonds. Alongside a significant equity portfolio, these securities provided them with sufficient returns to meet their liabilities and matched them nicely enough.

Then the financial crisis hit. Stock markets crashed and regulators dropped interest rates right down before flooding markets with liquidity.

Investors, desperate to avoid heightened volatility, wanted to move out of the equities that had dominated their portfolios, but found their usual safe-haven bonds were not producing the returns they needed to close their funding gaps.

A knee-jerk rush out of expensive actively managed equity strategies into passive index trackers had instant appeal but over a longer time horizon hasn't solved the funding problem.

## **Passive takes a pause for thought**

While an excessive emphasis on low-cost, liquid strategies drove the shift toward high liquidity, high volatility passive strategies, the associated risks were not always adequately remunerated.

For example, volatility can be enhanced by lots of investors holding the same assets, as is the case with popular trackers. This exacerbates how those assets move in moments of stress or if there is a mass decision to sell out of a security or sector. Managing this volatility is one potential benefit investors sacrifice when moving away from active management.

### **Turning an eye to alternatives**

Investors are now looking further than just cheap equity portfolios to expand their horizons.

We are seeing our clients becoming more comfortable with embracing the huge risk spectrum that fixed income has to offer. Pension funds are climbing further up the risk curve – and getting more comfortable with this positioning.

We believe the next step for investors in getting more familiar with this new risk profile is by understanding it properly and learning how it functions within both their portfolios and different market environments.

However, to move forward, investors will have to unlearn some of the classic lessons of the past. For example, some are beginning to shake off the comfort of holding debt issued by familiar (and therefore perceived 'safer') US names, when it falls into the high yield ratings category. Instead, a revised mindset is leading them to consider assets outside their usual field of vision.

Emerging market corporate debt is becoming an interesting new option in our view, with investors considering it alongside traditional investment-grade names thanks to its track-record of providing quality cashflow.

### **Walking the funding path**

With all pension investors on the same journey towards being fully funded, they require exposure to risk from a diversified range of sources in order to reach their financial destination. These can span equity markets, liability-driven investments and assets that insurance companies will want to take on in the event of a buyout.

Additionally, we believe there are fundamental risks that alternative investments can help mitigate in a portfolio, too. Fixed income has always been a good way to match interest rate moves, but inflation is an important one to consider, as pension trustees have a duty to protect the purchasing power of the benefits they pay to members.

Outside of inflation-linked government bonds, the issuance of which is much smaller than the needs of UK pension funds, investors need other options to match this variable rate.

### **New matching**

One way to keep up with inflation is through capturing uncorrelated spreads of inflation-sensitive assets, such as infrastructure with pricing power; macro strategies, which can tactically use a range of assets and derivatives; distressed situations with equity kickers or by investing in a floating manner, which captures the policy response to increase in asset prices.

This type of matching has become increasingly popular with the onset of de-risking by pensions that are approaching maturity and have little need for further growth to meet their liabilities. However, this group, for the moment, is still a relatively small cohort and trustees remain focused on closing their funding gap with the most efficient risk budget they can create.

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