Investment Consulting

Investing in Alternatives – What Are Swiss Pension Funds Considering?

EPFIF

Some of the graphs/pictures are not available online

PPCmetrics AG
Dr. Diego Liechti, Senior Investment Consultant

Zürich, June 15, 2017
Structure Of My Talk

• Introduction
• The «Menu»
• What Are Swiss Pension Funds Doing?
• A Look Abroad: Yale Endowment
• What Are Swiss Pension Funds Considering?
• Questions To Be Answered Before Investing
• Take-Aways
An alternative investment is an asset that is not one of the conventional investment types, such as stocks, bonds and cash. Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of the complex natures and limited regulations of the investments.

Source: http://www.investopedia.com

- What are typical alternative investments?
- How do pension funds invest? What are they considering?
- How should you evaluate them?
The «Menu»
Overview

Alternative Investments

- Absolute Return
  - CTA
  - Event Driven
  - Absolute Return Bond
- Alternative Fixed Income
  - Non-Agency MBS
  - ABS
  - CoCo
  - CLOs
- Private Markets
  - Private Equity
  - Infrastructure
  - Clean Energy
  - Transportation
  - Private Debt
- Natural Resources
  - Commodities
  - Agriculture / Farmland
  - Timber
- Real Estate
  - Commercial
  - Residential
  - Industrial
- Other
  - Insurance Linked Securities
  - Microfinance
  - Wine
  - Art
The «Menu»
Growth Story

Source: PWC (2015)
What Are Swiss Pension Funds Doing? Diversity In Asset Allocation?
What Are Swiss Pension Funds Doing?
Alternative Asset Allocation

Alternative Assets according to Strategy

* No data before 2015
Source: Swisscanto Pensionskassenstudie 2016
What Are Swiss Pension Funds Doing?
What Type Will Be Increased?

What kind of alternative assets will be increased?

* No systematic mentioning
Source: Swisscanto Pensionskassenstudie 2016
A Look Abroad
The Yale Endowment: Target Allocation

The Yale Endowments' 2016 target allocation

- Cash: 2.5%
- Absolute Return: 22.5%
- Foreign Equity: 15.0%
- Leveraged Buyouts: 15.0%
- Venture Capital: 16.0%
- Real Estate: 12.5%
- Natural Resources: 7.5%
- Domestic Equity: 4.0%
- Fixed Income: 5.0%
- Natural Resources: 7.5%
- Real Estate: 12.5%

Source: Yale
A Look Abroad
The Yale Endowment: What About Swensen’s Personal Philosophy?

According to *unconventional success: A fundamental approach to personal investment*:

- Construct a portfolio with the following *6 asset classes*: Domestic Equities, U.S. Treasury Bonds, Inflation Linked Bonds, Foreign Developed Country Equity, Emerging Market Equity and Real Estate
- **Rebalance regularly**
- In the *absence of confidence in a market-beating strategy*, invest in low-cost index funds.

How does this fit with Yale’s strategic asset allocation?
A Look Abroad
The Yale Endowment: Performance Attribution

Added Value of Alternative Assets?
What Are Swiss Pension Funds Considering?
«Hot Topics»

Core Portfolio

Satellite

- Energy Infrastructure
- Infrastructure
- Insurance Linked
- Private Debt
- Microfinance
- Private Equity
- Senior Secured Loans
- Volatility
- Microfinance
- CTA
- Multi-Assets
- Timber
- Securitized Bonds (ABS)
What Are Swiss Pension Funds Considering? Questions To Be Answered: General Approach

Is the risk premium / «alpha» unique in the asset allocation of the pension fund?

- Yes
  - Is there a cheaper way?
    - Yes, stop
    - No, invest
  - Do costs eat benefits away?
    - Yes, stop
    - No, invest

- No
  - Has the pension fund enough exposure already to it?
    - Yes, stop
    - No, invest
  - Is there a cheaper way?
    - Yes, stop
    - No, invest
What Are Swiss Pension Funds Considering?
Questions To Be Answered: Example Private Equity

• Private Equity returns can be decomposed into:
  – Equity Risk Premium
  – Small Cap Risk Premium
  – Illiquidity Premium
  – «Alpha» (?)

• Does the pension fund have enough exposure to those premia?
  – Is there already exposure to small cap equity, private debt, (unlisted) real estate, … ? Is there an alpha?

• Can the pension fund invest in the asset class in an efficient way?
  – Management fee, costs from operational set-up, or monitoring
What Are Swiss Pension Funds Considering?
Watch Out: Illiquidity (1)

Normed Index value over time
Common period 01.01.2000 - 30.04.2017

- KGAST Immo Index (Schweiz)
- SXI Real Estate Funds
- SXI Real Estate Shares
- SPI

\[ \sigma_{KGAST} = 1.1\% \text{ p.a.} \]
\[ \sigma_{SXI \text{ Real Estate Funds}} = 6.4\% \text{ p.a.} \]
What Are Swiss Pension Funds Considering?
Watch Out: Illiquidity (2)

- Performance measurement and benchmarking
- Less flexibility (tactics!)
- Legacy for successor
- Patience and long breath
- Problems with rebalancing
- Run for illiquid investments reduces premium
- Measurement problems (i.e., returns, volatility, correlations)

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What Are Swiss Pension Funds Considering?
Watch Out: Problem Of Self-Selection

e.g., IRR Marketing
What Are Swiss Pension Funds Considering?
Watch Out: Fee Structure

• Example: Catch-up in Private Equity
  – Return of 12% p.a. (after management fee)
  – Carried interest 20% after a hurdle rate of 8%

<table>
<thead>
<tr>
<th></th>
<th>100% Catch-up</th>
<th>No Catch-up</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>LPs</td>
<td>GP</td>
</tr>
<tr>
<td>First 8%</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>Next 2%</td>
<td>2%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Remaining 2%</td>
<td>1.6%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Total</td>
<td>9.6%</td>
<td>2.4%</td>
</tr>
</tbody>
</table>

– Fees can be much higher depending on «small» details such as a catch-up. ¹

* In this example roughly 60%, assuming a management fee of 2%
Take-Aways

1. There are many alternative investments worth considering.
2. Evaluation of alternatives should be done with care.
3. Be critical and avoid major pitfalls.
4. And remember Swensen’s advice as well as:

   Boring assets provide better risk-adjusted returns than speculative peers. One explanation is the lottery ticket story. … another explanation is the leverage aversion.

   Antti Ilmanen

   Source: Journal of Investment Consulting
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