

Stormy weather

in the capital markets

We believe that pension funds are exposed to more risks now than at any point in the last 30 years. This has nothing to do with pension funds themselves, but with the way the economy and markets are moving. How should pension funds react to the changing environment?

■ In our view, pension funds should diversify away from equities into other assets such as property, high yield and emerging debt, and hedge funds. We recognise that this represents a major policy shift for most funds, but it will result in lower risk without giving up too much expected return.

■ Some pension funds will consider other types of assets to hedge against risk. These assets might include derivative products such as long-dated fixed-income strips or options.

■ We also recommend that pension funds consider dynamic asset allocation, adapting their benchmarks to reflect big shifts in bond and equity valuations.

■ In order to implement these new strategies, pension funds will need to increase their governance substantially.

These policy shifts will be necessary because the ground rules seem to be changing for investors. Over the long term, we believe that

bond yields will remain low and that equities are less attractive as a way for pension funds to meet their liabilities.

Demographics will also help depress bond yields. An ageing population means more people (or their pension funds) buying bonds than equities. Over the long term this may mean downward pressure on equity values and upward pressure on the value of long-duration debt, leading to lower bond yields.

Double the risk

Over the next decade, we expect investors' asset allocation processes and governance to reflect their changing perceptions. Already, investors are increasing their focus on risk and capital preservation. This is different from the last decade when there was a focus on return rather than risk.

Following the recent sharp falls in equity markets, equity and bond prices have relationships that would indicate the possibility of strong equity performance relative to gilts over the next 20 years or so.

But the price that investors are paying for those high expected equity returns (for instance, equity risk) has doubled since 1997 to about 20% experienced volatility a year. This is backed up by options pricing which indicates that markets

expect this high risk to continue into the future. Therefore, pension funds that base their asset allocation on risk may not be able to afford the higher price of equity investing, and may move to bonds instead.

Worse still, deflation might make equities even riskier relative to bonds. The bond/equity relationship is key to pension funds because of the bond-like structure of their liabilities. The bad news is that as inflation falls towards zero, evidence suggests that the correlation between equities and bonds will turn negative.¹

This is crucially important for pension funds: a negative correlation between equities and bonds would further increase the risk of equities relative to liabilities.

The threat of deflation is already reflected in the markets. For the first time ever, the bond markets are pricing the risk of deflation as equal to the risk of high inflation.

The Japanese experience shows the damage that deflation can wreak. A Japanese pension fund that was fully funded and 100% invested in equities in 1990 would currently be less than 20% funded on an FRS17 basis.

Very few assets will do well in a deflationary environment. As well as

long-dated government bonds, derivative instruments such as fixed-interest strips might provide protection for pension funds. Interest rate options might also provide some protection.

Thinking smarter

Against this backdrop, we believe that it makes sense for pension funds to 'think smarter' about how best to employ their assets.

We have identified five types of risk that funds can use to increase return. These are:

- equity risk premium
- inflation
- duration
- skill/trading (hedge funds)
- liquidity risk premium (property, private equity).

Of these five, the last two are under used. Pension funds are not adding as much value as they could

through skill, because they continue to use typical active managers who return less than their fees.

Similarly, by investing in comfortable, liquid, quoted assets, funds are not profiting from liquidity risk, which could generate 0.5-2% added return a year

depending on the asset (corporate bonds at the lower end of the return spectrum; property and private equity higher up).

However, there is a big drawback to liquidity risk - it is tough to tell just how big the risk is. While it will be low most of the time, there may be periods of very high risk. The advantage is the high potential payoff. Over the past 10 years, hedge funds, property, private equity and global high yield bonds have delivered similar returns to equities,

but with far less risk. Certainly a mix of these other assets with equities has provided benefits in terms of risk reduction without too great a fall in return.

In these volatile markets, pension funds might also benefit from a more dynamic approach to asset

"Equity risk has doubled since 1997."

allocation, changing their benchmarks occasionally to take advantage of big shifts in equities or bonds.

To sum up, we believe that the next decade will be a very challenging one for pension funds. To meet the challenges, pension funds will need to think smarter, and to increase their governance to cope with new strategies.

¹ Gibson's Paradox 1932. The last period of low and falling inflation was the 1930s.

Can funds be more creative?

