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# Absolute Return Strategies

## A Pensions Perspective

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# Agenda

- ◆ Why absolute return? And why now?
- ◆ Less  $\beta$ , more  $\alpha$
- ◆ Sample asset allocation

# Absolute Return – Why Now?

## 1990

- ◆ (Fairly) static liability valuation bases:
  - Low volatility
  - Surplus increases if real asset return  $>$  assumptions
  - Absolute return strategies fairly attractive they'd been recognised

## 2005(ish)

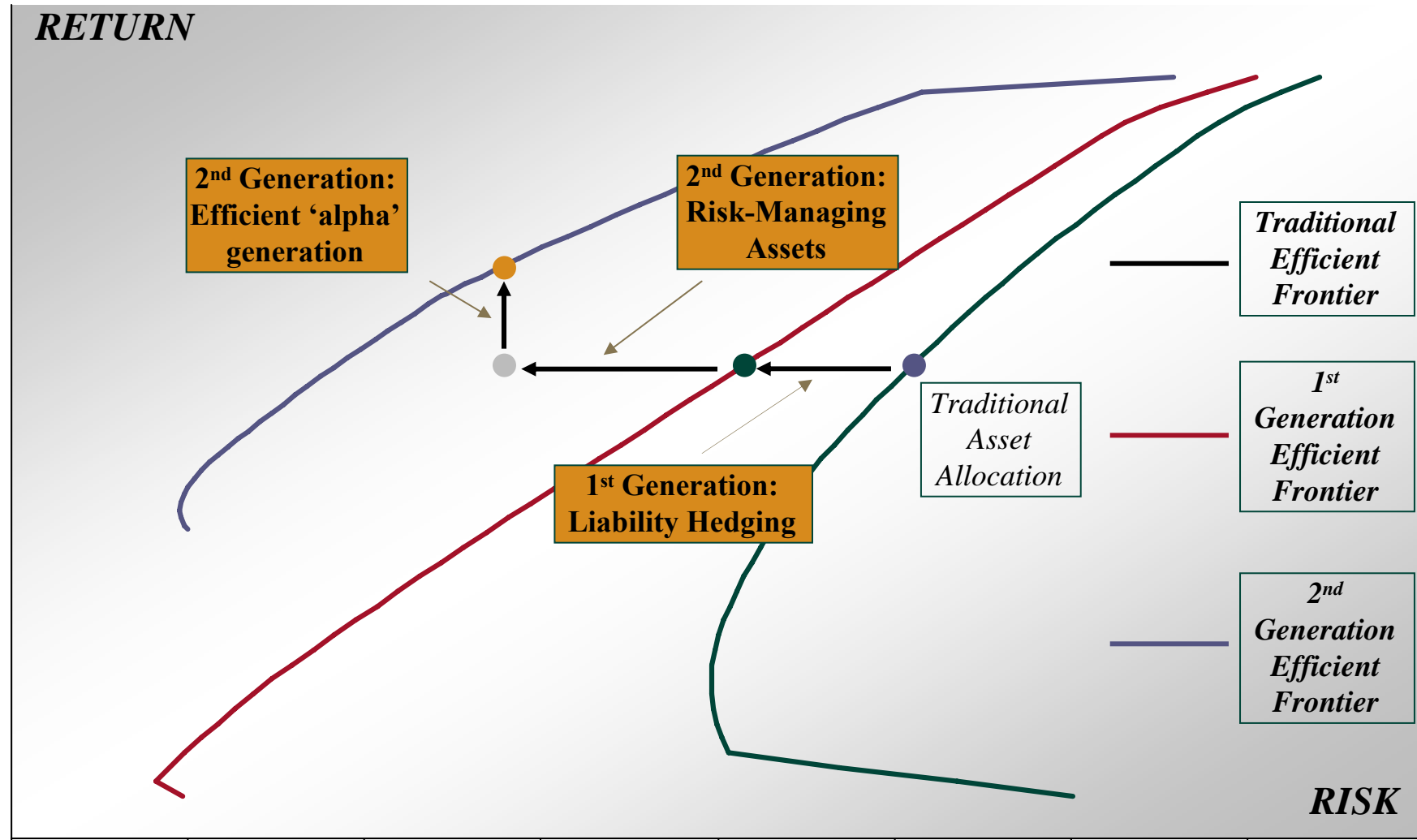
- ◆ Liabilities marked-to-market
  - Bond-like and volatile
  - LDI hedging unusual
  - Focus on asset performance relative to liabilities
  - Absolute return strategies less attractive except as diversifier from traditional assets

# Absolute Return – Why Now?

2006 / 7 onwards

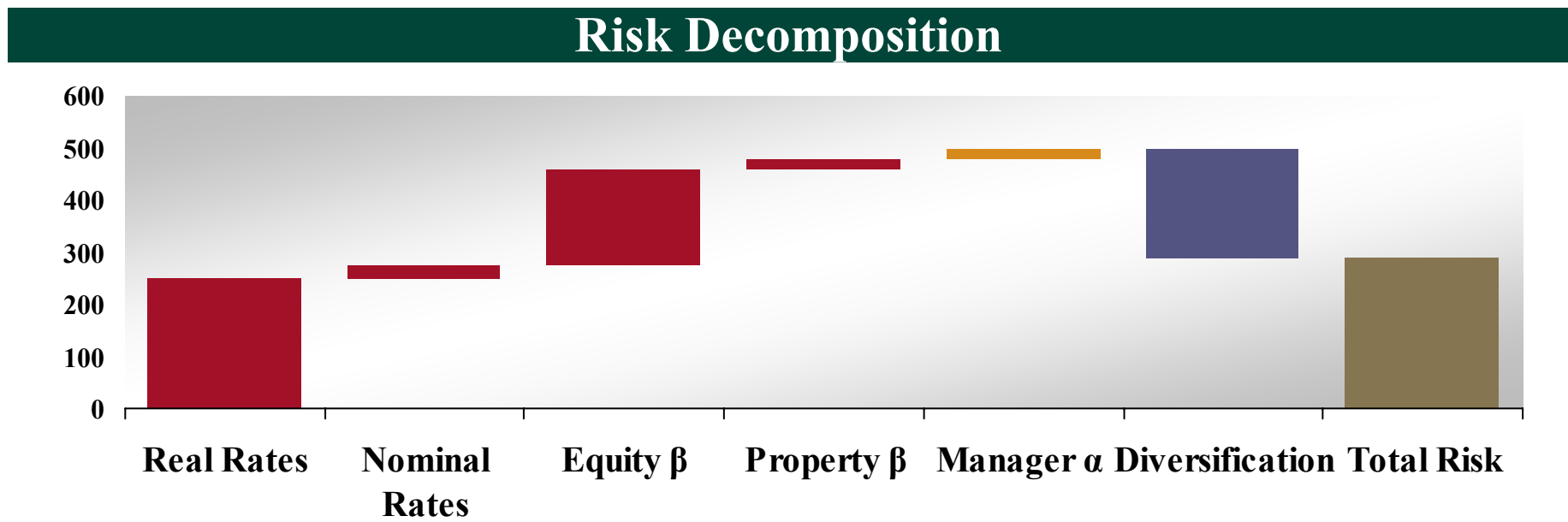
- ◆ LDI mainstream:
  - Liabilities marked-to-market, hedged back to LIBOR
  - Absolute return well suited to LIBOR benchmark
- ◆ For those funds not adopting the LDI approach:
  - Absolute returns for diversification (smaller allocation)

# The Development of LDI



# Risk Management

- ◆ Biggest risks usually real / nominal rates & equity  $\beta$
- ◆ Manager  $\alpha$  relatively small source of risk
- ◆ More  $\alpha$ , less  $\beta$  would lead to better diversification of risk budget...
- ◆ ...but  $\alpha$  is more expensive than  $\beta$



# What Strategies?

- ◆ ‘Absolute Returns’ not uniquely defined, but generally less  $\beta$ , more  $\alpha$ :
  - Strategies benchmarked vs LIBOR e.g. hedge funds, long-short products (especially market-neutral)
  - Some capital guaranteed structures e.g. credit-based CPPI, capital guaranteed commodities
  - Short-duration structured credit (CDOs)
  - Infrastructure / timber
  
- ◆ Or, stretching the definition:
  - ‘Low-volatility’ equity e.g. cash + call options

# Sample Pension Fund Allocation

Asset Mix	%	Expected Returns
UK Equity	25%	7.50%
Global Equity	25%	7.50%
UK Credit	15%	5.20%
UK Nominal Gilts	15%	4.55%
UK IL Gilts	15%	4.35%
HFoF	5%	7.00%

– Projected Forward Funding Ratio in 10 years = **92%**

– Downside Risk = **45%**

– 1 Year VAR<sub>95</sub> = **£72m**

– Probability of Hitting 105% Target = **29%**



# What About ‘Classical Derisking’?

Asset Mix	%	Comments
UK Equity	10%	<i>Both nominal and real rate risks hedged out on fixed income assets</i>
UK Credit	30%	
UK Nominal Gilts	30%	
UK IL Gilts	30%	

– Projected Forward Funding Ratio in 10 years = **78%**

– Downside Risk = **70%**

– 1 Year VAR<sub>95</sub> = **£18m**

– Probability of Hitting 105% Target = **0%**

# Try A More Sophisticated Solution

Asset Mix	%	Comments	
UK Credit	15%	<i>Both nominal and real rate risks hedged out on fixed income assets</i>	– Projected Forward Funding Ratio in 10 years = <b>93%</b>
UK Nominal Gilts	15%		– Downside Risk = <b>59%</b>
UK IL Gilts	15%		– 1 Year VAR <sub>95</sub> = <b>£51m</b>
HFoF	5%		– Probability of Hitting 105% Target = <b>27%</b>
Risk Adjusted Equity (RAE)	50%	<i>Structured equity delivering similar return to index but with reduced volatility</i>	

# Putting It All Together

Step 1	LDI hedge – nominal and inflation swaps
Step 2	Reduce concentration in equity $\beta$
Step 3	Seek diversified $\alpha$

Asset Mix	%
Equity <i>15% traditional, 15% 'low vol'</i>	30%
Bonds <i>10% gilts, 10% investment grade corporates, 10% investment grade structured credit, 10% high yield (possibly with CPPI wrapper)</i>	30%
Property	10%
Alternatives <i>10% hedge funds, 5% private equity, 5% commodities, 10% infrastructure / timber / others</i>	30%

- Projected Forward Funding Ratio in 10 years = **111%**
- Downside Risk = **80%**
- 1 Year VAR<sub>95</sub> = **£31m**
- Probability of Hitting 105% Target = **53%**

# Conclusions

- ◆ Absolute return strategies fit better in an LDI world
- ◆ Trend away from  $\beta$  towards  $\alpha$ , but  $\beta$  is cheaper and still has a significant role to play
- ◆ Diversification into broader range of alternatives
- ◆ Trade-off between investment efficiency and complexity – most (smaller) funds unlikely to go all the way?