For professional clients only

How to preserve capital yet generate returns?

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Introduction

Most pension funds need to generate returns to close down their pension deficit. Capital preservation in falling markets is an important part of the process on the journey to being fully funded. Whether clients are looking for capital preservation tactically (to allow them to opportunistically time entry into market lows) or strategically (to reduce portfolio volatility), the question remains: Where do they look?

Is there something that can protect their assets in falling markets yet generate decent returns in normal market conditions?

Increasing importance of alpha as a diversifier

Institutional investors have typically turned towards government bonds and gold as a source of capital preservation. They have delivered well on this front but can they continue to do so? Unprecedented central bank policy action, as well as the trend towards extremely low interest rates has been reflected in government bond yields, which have even turned negative in some countries. Further policy action may have an increasingly limited impact on yields. Gold looks more attractive but making investments in gold can be challenging for pension schemes.

If further market falls do not materialise, both assets may struggle to generate solid returns in normal market conditions. **Alternatively, manager skill (or alpha) may deliver better returns yet also help mitigate downside in falling markets.**

Liquid alternatives can be a strong source of alpha. Given the dispersion of strategies, care must be taken to select the right ones. On one end of the spectrum, there are certain diversified growth funds that offer little more than access to asset class beta and on the other end of the spectrum, there are more sophisticated hedge fund strategies that truly offer a return-stream with little or no correlation to equities.

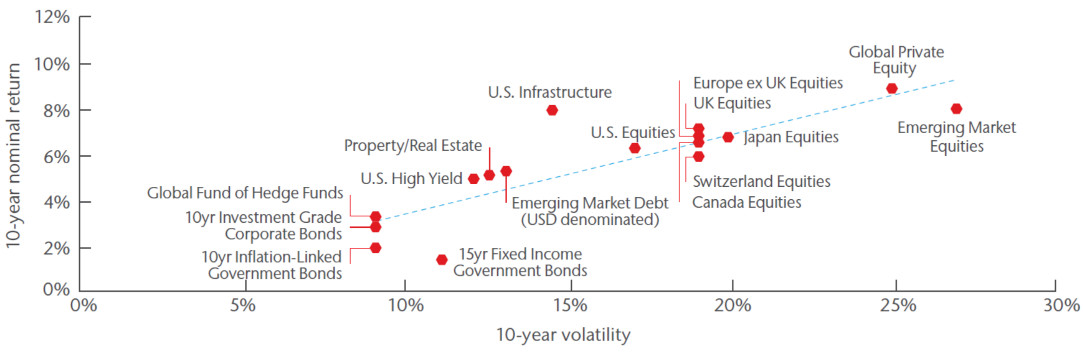
Cross-asset correlation has been on the rise in recent years, exaggerated in times of market stress. The Q1 2020 market turmoil was no exception. **This meant that liquid alternative diversifiers relying on traditional market exposures (or beta), were less effective than those relying on manager skill (or alpha) for capital preservation.**

Arguably these stressed environments are when capital preservation is most important, when you need something to deliver true diversification away from equities to mitigate the equity downside. **There's no point paying for beta even if it is cheaper, when alpha is required.**

Hedge funds' contribution to the investment strategy

Hedge funds are extremely efficient relative to other asset classes in that they have a high Sharpe ratio (i.e. they deliver a high level of return given the level of risk taken on). They have bond-like volatility but achieve greater returns.

Risk–return based on Q1 2020 Capital Market Assumptions



Source: Aon's Capital Market Assumptions as of March 31 2020.
Past performance is not a guide to future returns

Broadly speaking, hedge funds can improve an investment strategy by producing a more efficient portfolio. They improve overall risk-adjusted returns by providing an uncorrelated source of return, regardless of market direction.

There is a wide array of hedge fund strategies with different performance objectives and risk profiles. It is vital to choose the type(s) of strategy that suits your needs. **If capital preservation and reasonable growth is the goal, more uncorrelated strategies (e.g. global macro, trend-following, etc) would be a sensible solution.**

The lower correlation to equities results in the overall portfolio having a more stable experience (or less volatility), delivering some capital preservation during equity downside and some return generation (though not as buoyant as equities) during equity upside.

Do pension funds really need capital preservation?

Do pension funds really need capital preservation? Pension funds are long-term investors and may be able to stomach high equity volatility but they are still subject to shorter-term objectives. Volatility can be painful if market falls coincide with actuarial exercises such as the triennial valuation, as some pension funds found out painfully in the market turmoil earlier this year.

The Pensions Regulator is increasingly encouraging Trustees to have a clearer plan over shorter timescales. Investing in hedge funds as part of a well-diversified portfolio can improve the efficiency of a pension fund's investment portfolio. By this, we mean that the portfolio can still achieve the required expected return but does so in a way which minimises the downside risk. This in turn reduces the volatility of outcomes relative to the Trustees' strategy to achieve full funding.

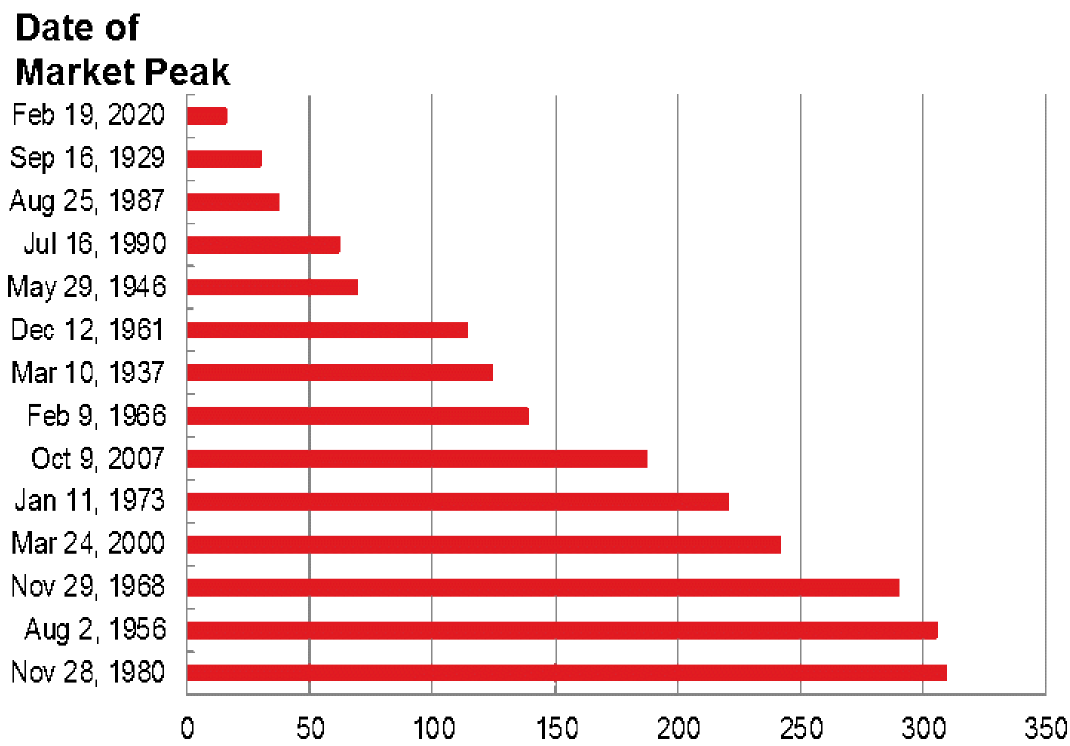
Is now the right time to diversify away from equities?

The next market tumult may not be a repeat of the Q1 2020 market turmoil but if there is imminent market stress, it's likely to be caused by the realisation of COVID-19 fears or its longer-term impact. Thus, there could be a great deal of overlap with the experience and drivers observed in the recent turbulence.

We witnessed an equity bear market, which developed in the shortest time-period we have ever seen. Pension funds that managed to mitigate the downside invariably had already diversified away from equities.

Pension funds wanting to preserve capital in the next market tumult may benefit from preparing now, while markets are still relatively complacent.

Number of trading days to close down 20% or more from its peak



Source: Aon Calculations, S&P, Factset

Timing the equity switch into hedge funds

Hedge fund allocations are typically funded from equities so we explore the timing of this in further detail. Hedge funds have lower volatility than equities so tend to outperform equities when equities fall, and underperform equities in normal market conditions.

This gives rise to a catch-22 situation where it's never a good time to make the switch. It's hard to forsake cheap equity upside in favour of a more expensive solution and it's hard to crystallise equity losses. **Looking beyond this mental barrier reveals an attractive time to be switching out of equities.**

Equities have rebounded swiftly and are not far away from their all-time highs which means pension funds would be locking in some gains. Additionally, there is a meaningful probability of another tail risk scenario for equities. The impact of curtailing economic activity is still feeding through to equity as well as economic data and a potential second wave scenario looms as governments start to ease lockdown measures.

Cost of alpha, not beta

When considering the range of liquid alternative strategies, there's no point paying for those reliant on beta because it is cheaper, when alpha is required for actual protection. In the same way a t-shirt may be cheaper than a raincoat, but it would not actually protect you when it rains.

Delivering alpha requires unique skill which is more costly, as the expertise is not easy to develop. Strategies that used to be considered 'alpha' are now available relatively cheaply as they become commoditised.

Consistently generating alpha requires constant evolution along with significant dedication of resources. It can be worth paying more to access returns that are not accessible through traditional routes, especially if this can offer some protection when traditional markets suffer deep drawdowns whilst simultaneously offering attractive return generation in normal market conditions. **There's a good balance to be struck between benefiting in both falling and rising markets.**

Additionally, fees are generally in line with what you would pay for private markets strategies, but without the need to lock up your capital for 5-10 years. **If pension funds are happy to experience the return (net of fees) profile, this should mean they would be happy paying the higher fees.**

Summary

- Higher cross-asset correlations in market stress result in alpha-based liquid alternative diversifiers (hedge funds) being more effective at capital preservation than those relying on beta.
- More uncorrelated hedge fund strategies result in the overall portfolio having a more stable experience (or lower volatility), delivering some capital preservation during bear markets and attractive return generation (though not as much as equities) in normal markets.
- The lower volatility of portfolios which include exposure to hedge funds means that there is a narrower range of investment outcomes, allowing Trustees to stick to their long-term funding plans.
- Pension funds wanting to preserve capital in the next market tumult may benefit from preparing now, while markets are still relatively complacent and while it is still an attractive time to switch out of equities into hedge funds.
- We believe that it is worth paying for the uncorrelated return stream generated by hedge funds – or manager skill – as this is a valuable diversifier within portfolios typically dominated by equity risk.

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