

The Outlook for Alternatives in Today's Economic Environment

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Outline

Part A: The Big Picture

Part B: Alternatives



Part A

The Big Picture



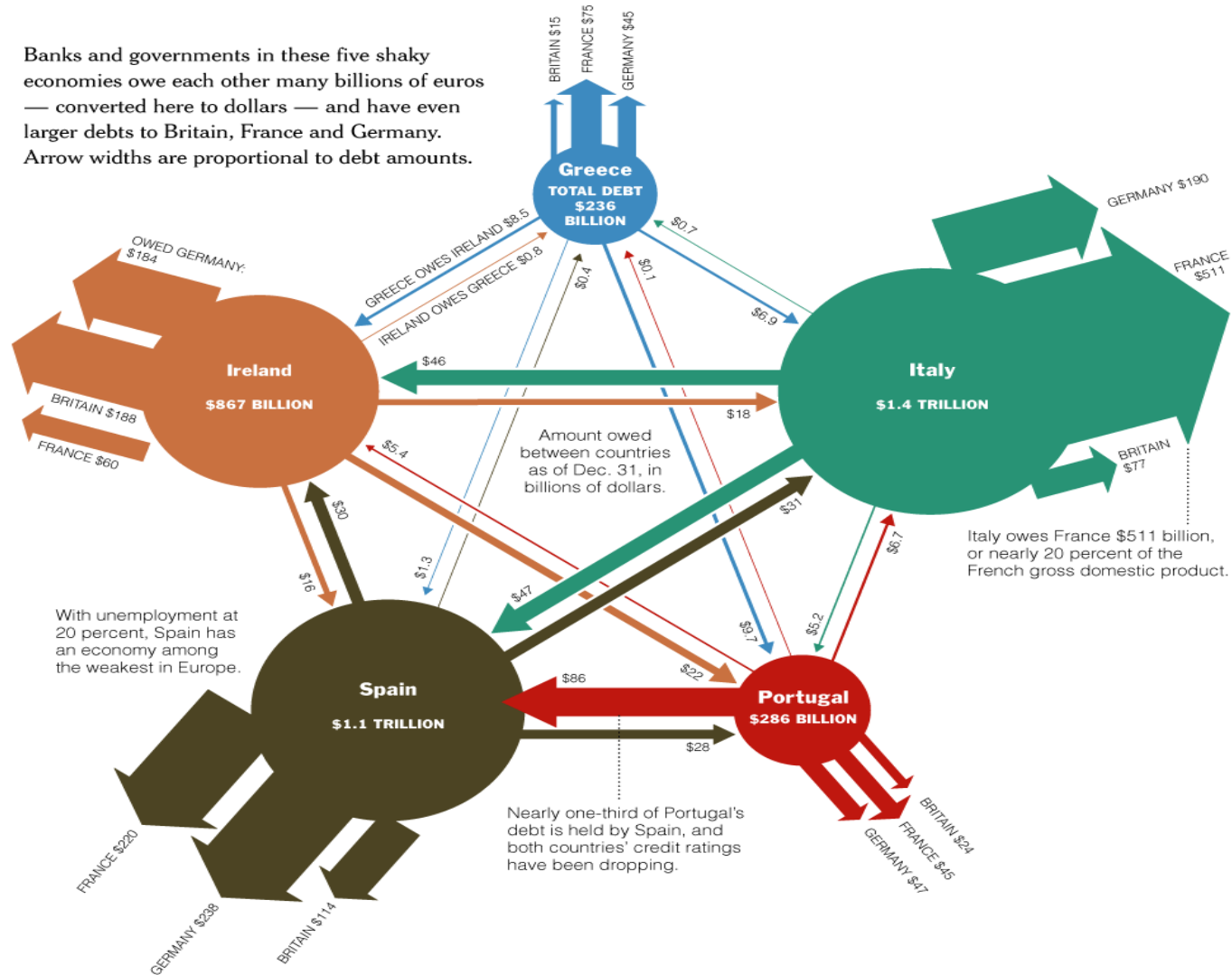
An uncertain economic environment

- A major discontinuity – “things will never be the same again”
- Today, an environment dominated by macro concerns
- The recovery is on!
- No, it's off!
- Hang on, we are back on again...
- Do fundamentals matter?
- Some of the things to worry about in coming years...



The European Web of Debt

Banks and governments in these five shaky economies owe each other many billions of euros — converted here to dollars — and have even larger debts to Britain, France and Germany. Arrow widths are proportional to debt amounts.



Source: Bill Marsh / New York Times. Based on public data from the Bank for International Settlements
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International contagion?

■ Europe is not an island

Exposures to Defaulting Country				
As December 2010*				
(\$ Billions)				
	U.S.	France	Germany	UK
Greece	\$41.5	\$65.0	\$39.9	\$19.02
Ireland	105.0	56.0	159.1	194.5
Italy	269.1	472.3	215.9	100.1
Portugal	46.5	32.2	50.2	29.1
Spain	178.9	175.5	224.0	137.8
Total	\$640.8	\$801.1	\$689.2	\$480.5

Source: Bank for International Settlements

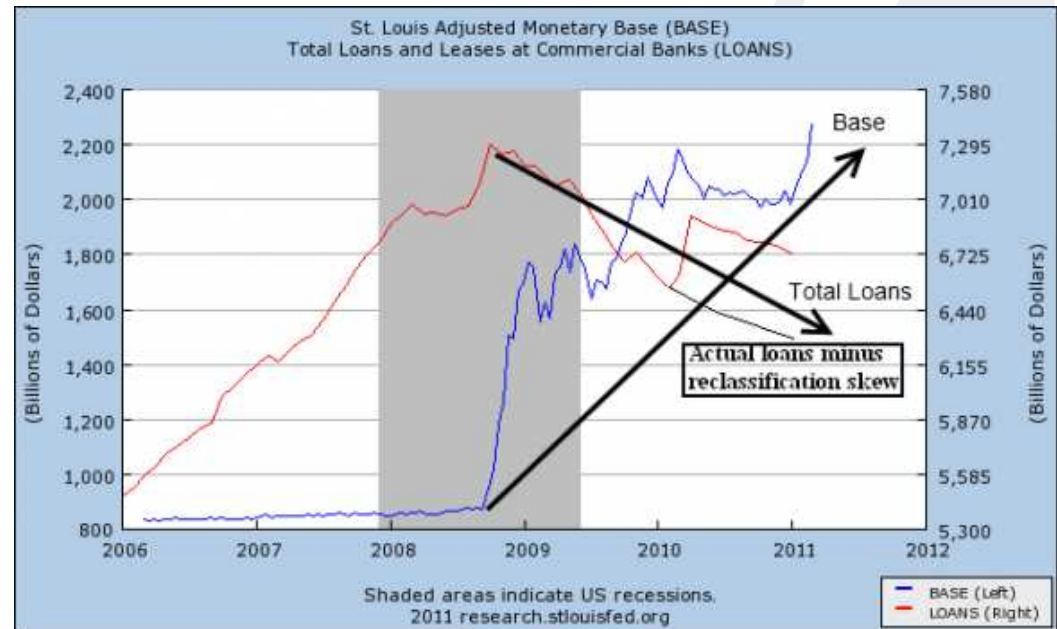
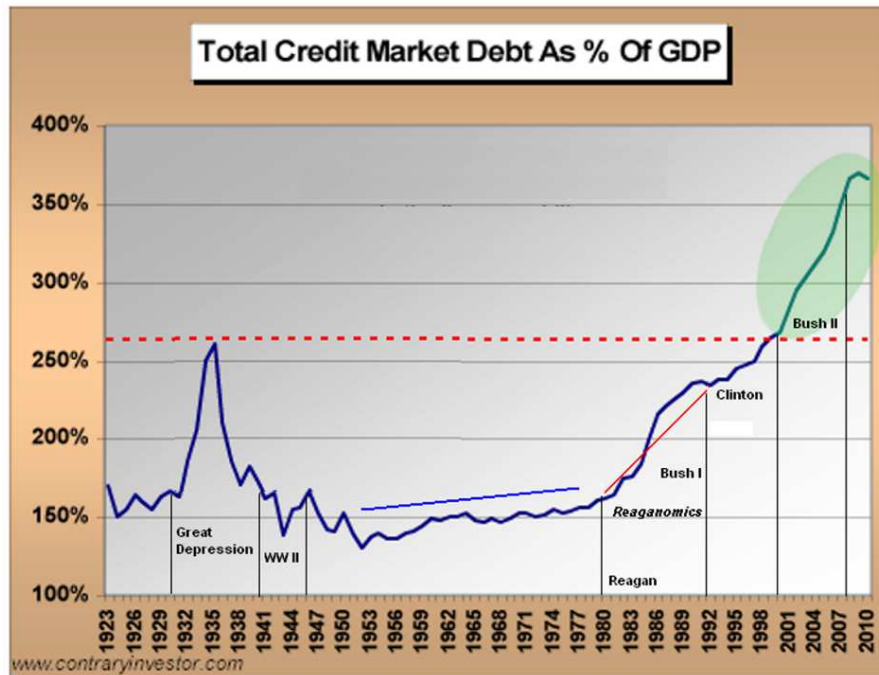
■ Other points of stress

- ▶ US state indebtedness
- ▶ Competitive devaluation



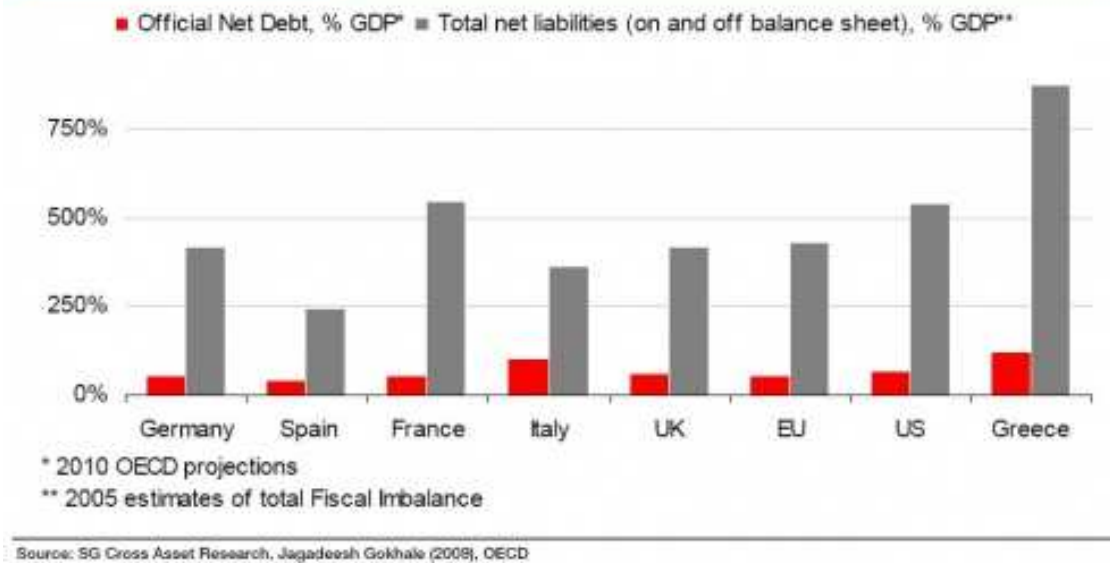
Inflation or deflation?

- A lot of deleveraging to go...
 - ▶ Deflationary pressures from the deleveraging under way in real economy yet to fully subside
- But the money supply is exploding
 - ▶ And inflation is hitting new highs in commodities and emerging markets
- Can you have both?



Total net liabilities are exploding

Our governments are insolvent: what's off-balance sheet dwarfs what's on ...



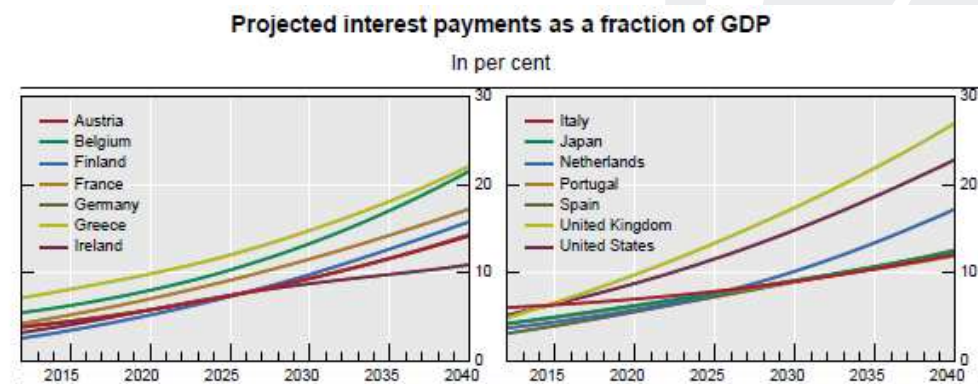
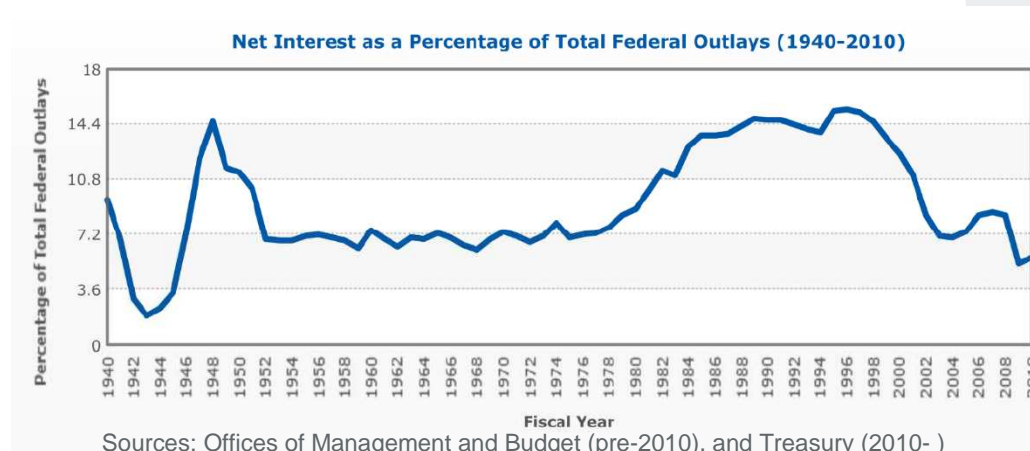
■ What's off balance sheet

- ▶ Public sector liabilities
- ▶ Pension obligations
- ▶ Medicare
- ▶ Etc.



Is the debt sustainable?

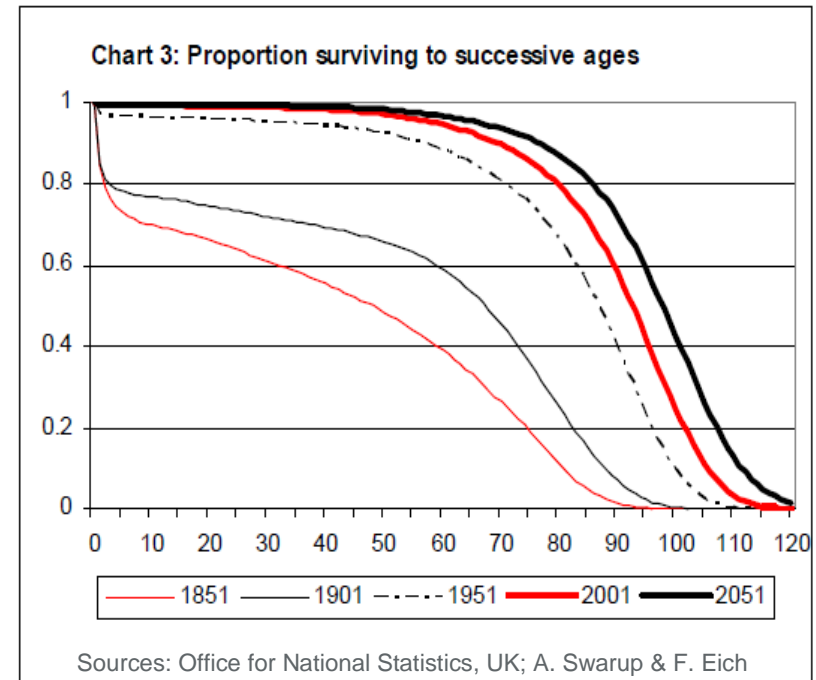
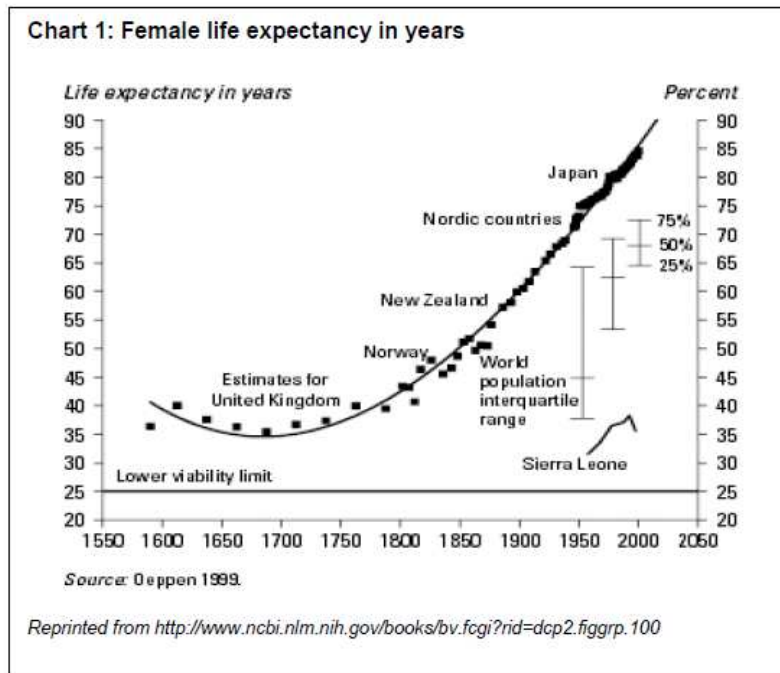
- The quantum of debt is not as important...
- ...as the interest you need to pay
- Economic recovery implies rising interest rates
 - ▶ Based on government budget projections, spending on net interest will rise from \$225 billion in 2011 to \$792 billion in 2021
- But that's just the near term!



Sources: OECD, Bank for International Settlements

The problem of longevity

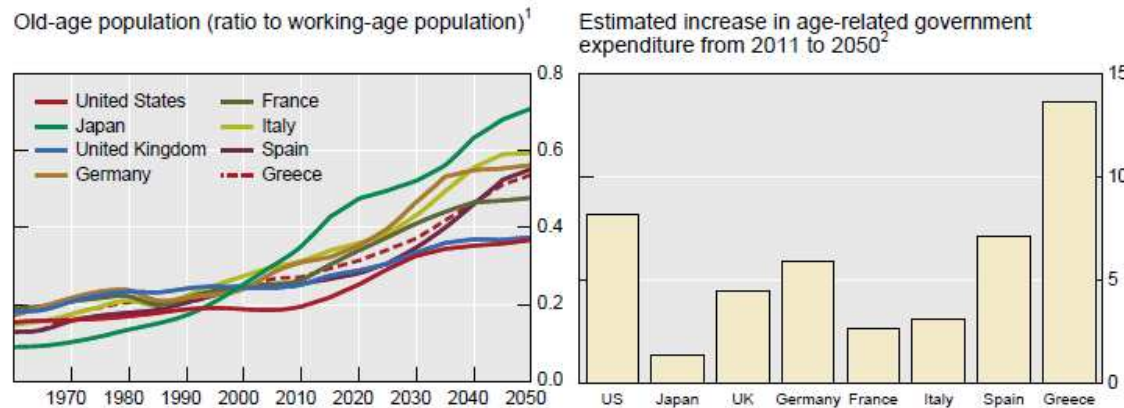
- Average life expectancy around 40 years for ages and then began to accelerate in 19th century
- On an upward trajectory ever since
- A notable achievement but also a profound impact, especially for pensions
- How bad can the bill get? Just look at the American Civil War pension scheme...



Demographic pressures are intensifying

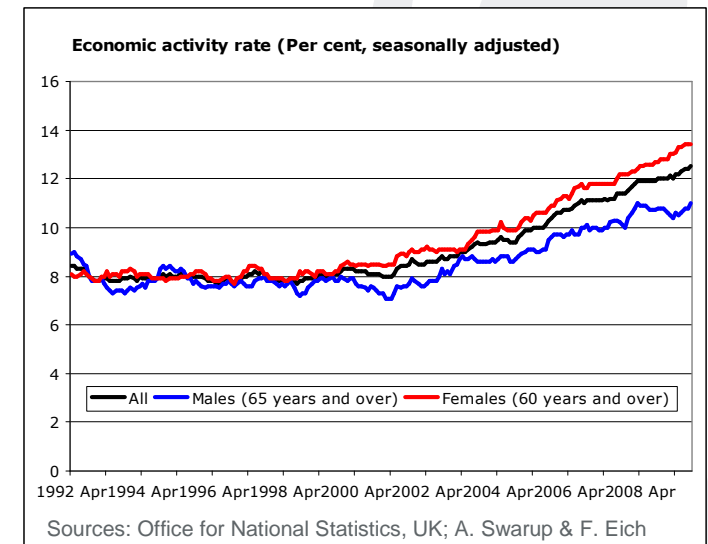
- Need to prepare for economic and fiscal consequences of population ageing, married to the retirement of the baby boomers
- Economic activity for over 65s continues to rise
 - ▶ Rise coincides with the first baby boomer generation reaching retirement
 - ▶ Probably partly due to people needing to work for longer
- In future, we will all likely be working for longer

Projected population structure and age-related spending



¹ Working-age population is between 15 and 64 years of age. ² In percentage points of GDP.

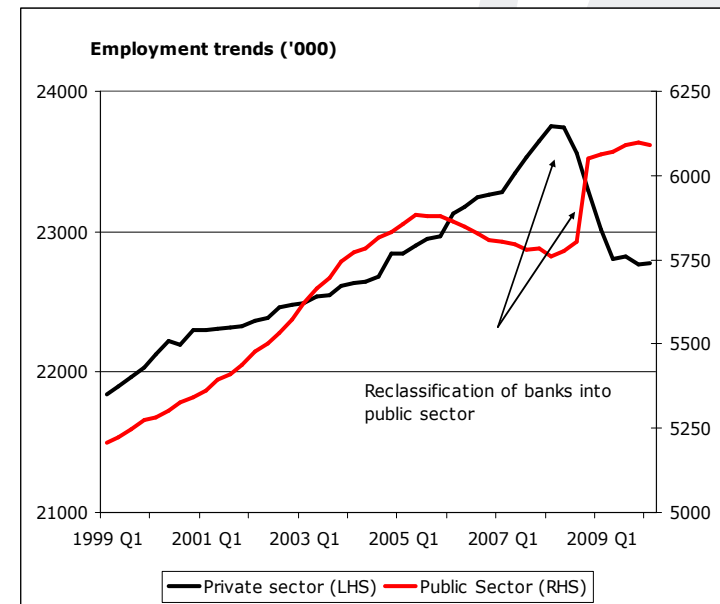
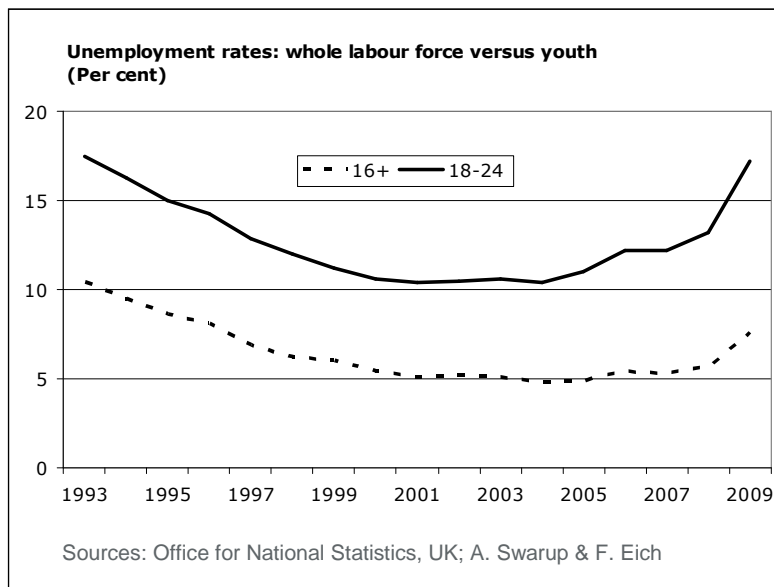
Sources: IMF, *World Economic Outlook, April 2007*; UN Secretariat; European Commission; Congressional Budget Office, Bank for International Settlements



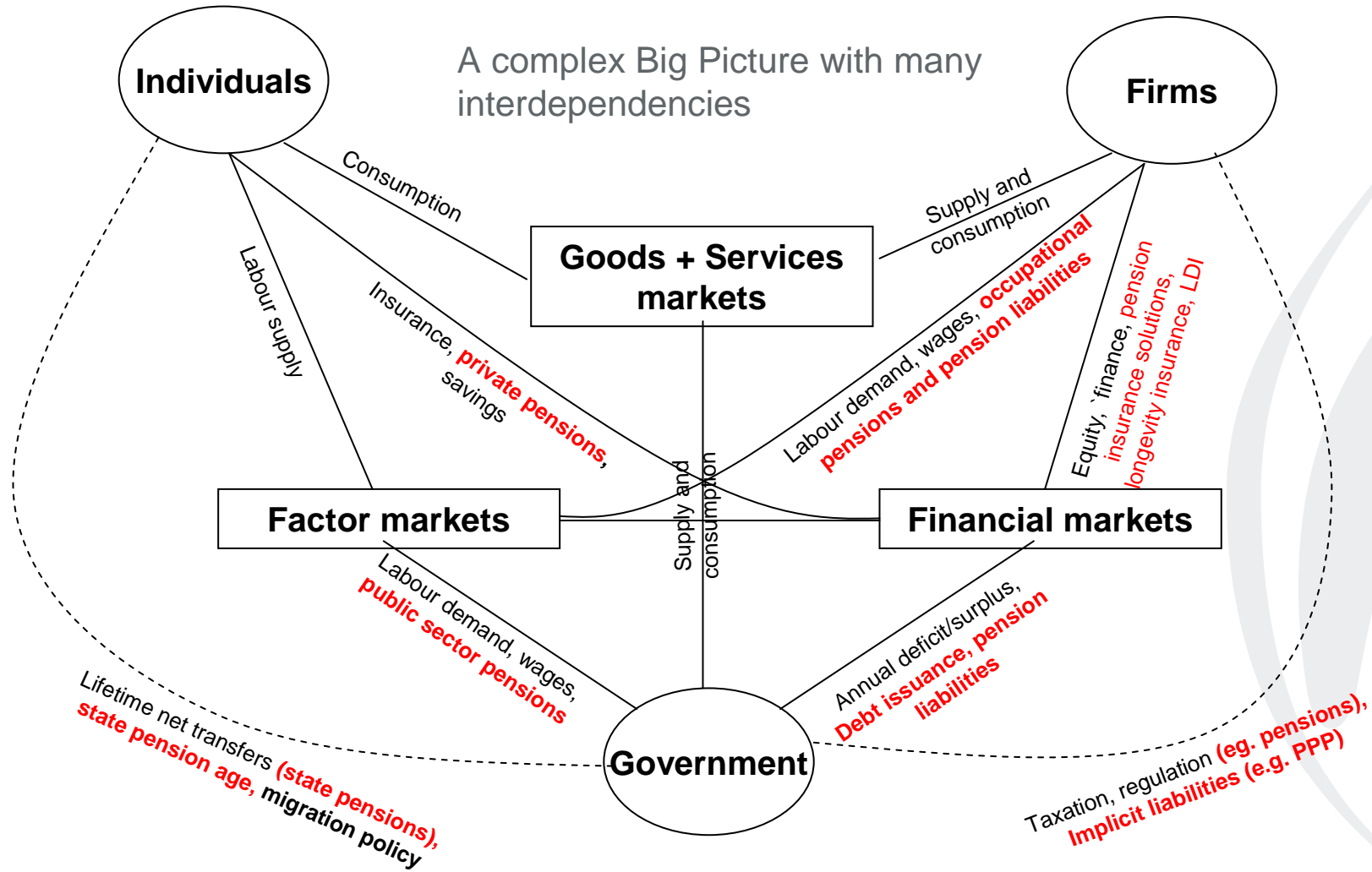
Sources: Office for National Statistics, UK; A. Swarup & F. Eich

Structural issues are deep...

- A major discontinuity – “things will never be the same again”
- Recent asset price recovery and improving economic outlook not mirrored in prospects for the pension system
- Deep recession and structural increase in unemployment (e.g. UK)
 - ▶ more people with broken employment records
 - ▶ younger cohorts particularly hard hit
 - ▶ public sector relatively protected but will feel pain now (though private sector not off hook yet either)



...and systemic



Source: *Pensions: A Complex Landscape*, A. Swarup & F. Eich (2008)

But we've been here before

- Greece, 400BC
 - ▶ The first banking bailout
- Rome 33AD
 - ▶ The first subprime crisis
- The Dark Ages
 - ▶ A century of inflation and the Hundred Years War
- The Great Depression
 - ▶ Sovereign default en masse
- And today...?



Part B

Alternatives



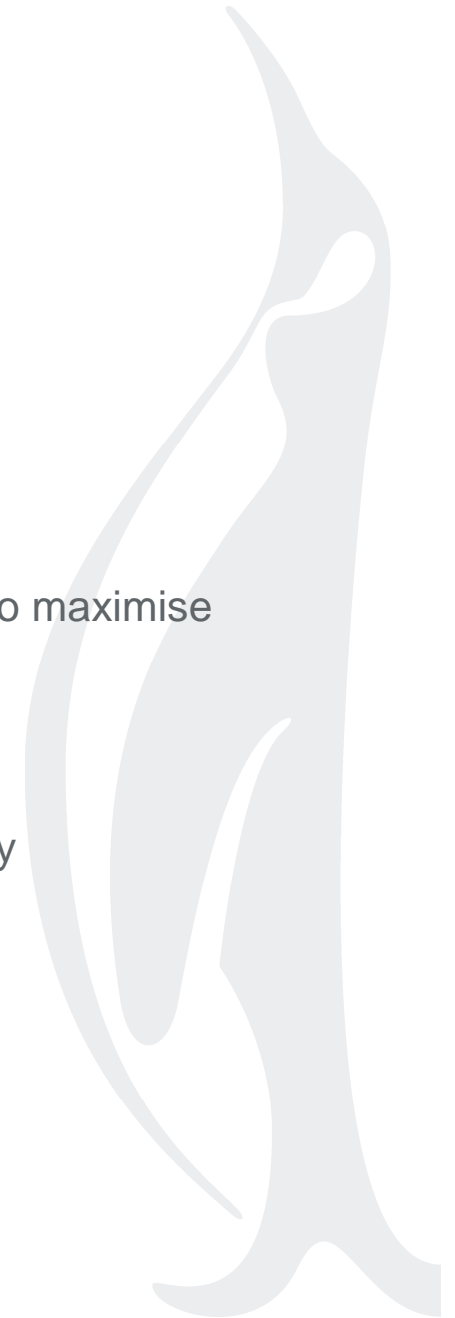
What is an asset class?

- Lots of different definitions
 - ▶ Instruments or strategies
 - ▶ Individual asset allocation framework
 - ▶ Regulatory definitions
- Where do hedge funds fit in?
- But notion of an asset class is somewhat meaningless by itself
- Main relevant questions are very different
 - ▶ What are the underlying risk factors
 - ▶ Does it provide a good risk-adjusted return?



The outlook for hedge funds

- Business cycles are getting shorter
- Dynamic management of risk is all the more important today
- Risks change and with them, the opportunity set
- The current environment presents many opportunities for managers
- For investors, important to be able to cycle between different opportunity sets to maximise returns and minimise risk
- All supportive of 'hedge fund' strategies
- A secular shift in allocations from institutional investors appears to be underway
- But...



Why hedge funds?

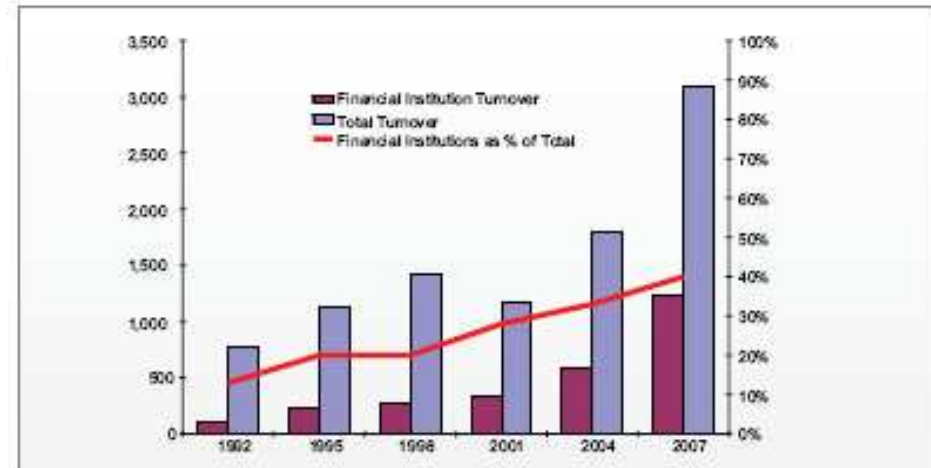
- Common investment rationale
 - ▶ Inefficient and (sometimes) liquid markets
 - ▶ Consistent (modest) returns
 - ▶ Uncorrelated returns to most other asset classes
- Are any of these true and / or sustainable?
- Take an example
 - ▶ FX strategies



Liquid and inefficient markets?

- A \$4 trillion daily turnover market
- Large amounts of passive investors mean potentially lots of inefficiencies
- Some can persist for years before collapsing, eg, the carry trade
- But % of financial institutions has also been growing strongly
- Growing competition for currency managers from other players – banks, macro funds, CTAs
- A liquid market does not equal no liquidity crunch
- You are not alone
- Risks enhanced – and sometimes mitigated – by herd behaviour

Exhibit 1: Foreign Currency Market – Average Daily Turnover

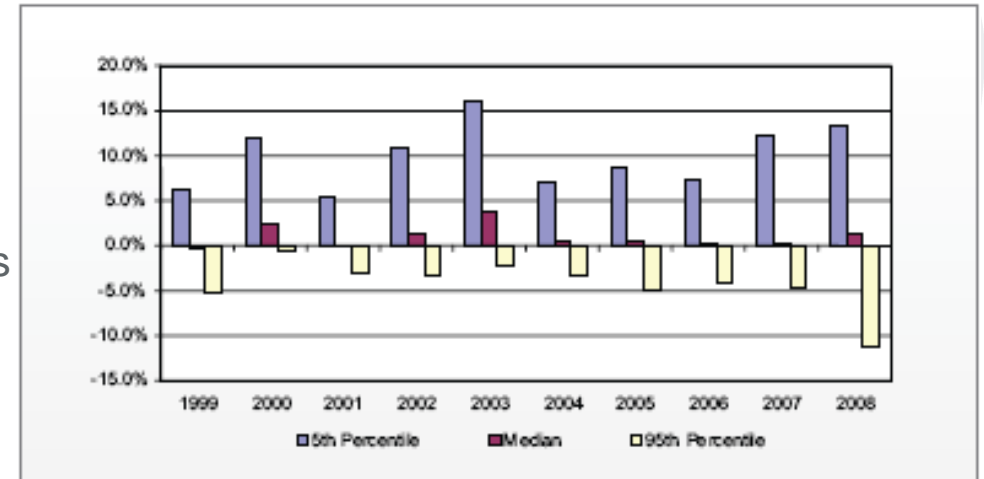


Source: Bank for International Settlements, Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity (2007).

Consistent returns?

- Opportunities clearly exist in all markets
- Current environment is attractive
 - ▶ Sovereign focus
 - ▶ Pivotal role of central banks and policymakers
 - ▶ A small globalised world
- All positive indicators for currency as an asset class
- Persistence of returns is high in the asset class
- BUT persistence of returns is low amongst managers
- Annual returns also mask high volatility and drawdowns

Exhibit 2: Currency Manager Performance



Source: eVestment Alliance, J.P. Morgan Investment Analytics & Consulting estimates.

Uncorrelated returns?

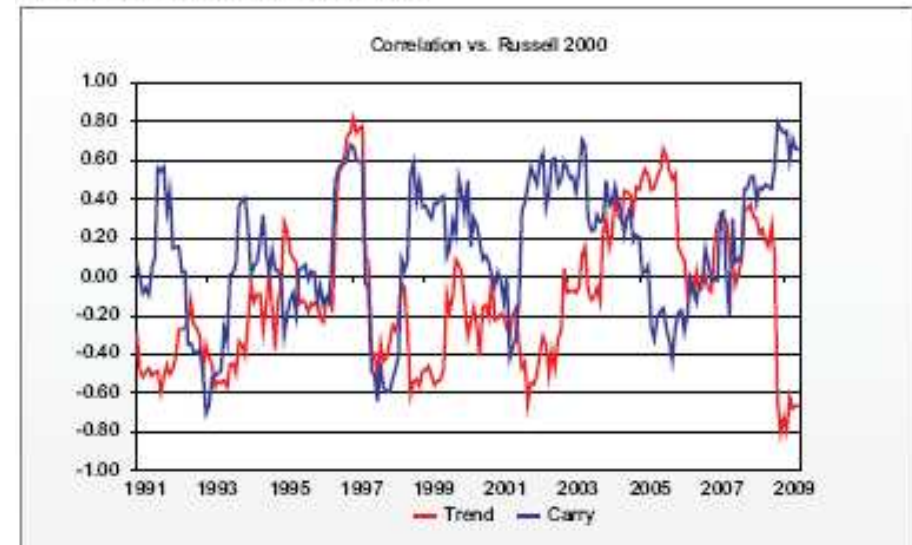
- Long-term correlations look appealing
- But vaunted low correlation over a cycle is meaningless
 - ▶ Same arguments made for FoFs, PE, commodities etc.
- Short-term correlations are far more important
- Most institutional investors have liabilities
 - ▶ Need correlations to be low in stressed situations, else the mismatch can worsen
- Not always true
 - ▶ End of 2008: Carry trade and equities had a correlation of 0.8

Exhibit 3 - Correlation Comparison (January 1990 - May 2009)

	All Markets			Down Markets		
	Carry	Trend	Value	Carry	Trend	Value
Barclays Aggregate	0.06	-0.01	-0.41	-0.28	-0.36	-0.45
MSCI EAFE	0.29	-0.19	-0.01	0.35	-0.18	0.06
Russell 2000	0.25	-0.26	0.18	0.39	-0.23	0.25
GSCI Commodity	0.25	-0.18	-0.06	0.08	-0.20	-0.17

Source: Bloomberg, Deutsche Bank, J.P. Morgan Investment Analytics & Consulting estimates.

Exhibit 4: Correlations over Time



Source: Bloomberg, J.P. Morgan Investment Analytics & Consulting estimates.

The conundrum of alpha and beta

- Two of the most abused words in the investment lexicon
- Not all managers are equal
 - ▶ Beta jockeys and alpha generators
- “**Beta is the market.**” But what does that actually mean?
- Alpha is a small town in New Jersey, population 2,369



Source: Wikipedia

Historical populations		
Census	Pop.	%±
1930	2,374	—
1940	2,301	-3.1%
1950	2,117	-8.0%
1960	2,406	13.7%
1970	2,829	17.6%
1980	2,644	-6.5%
1990	2,530	-4.3%
2000	2,482	-1.9%
2010	2,369	-4.6%

Population 1930 - 1990

Source: Wikipedia

- By definition, a small pool of talent will be heavily diluted in a large ocean



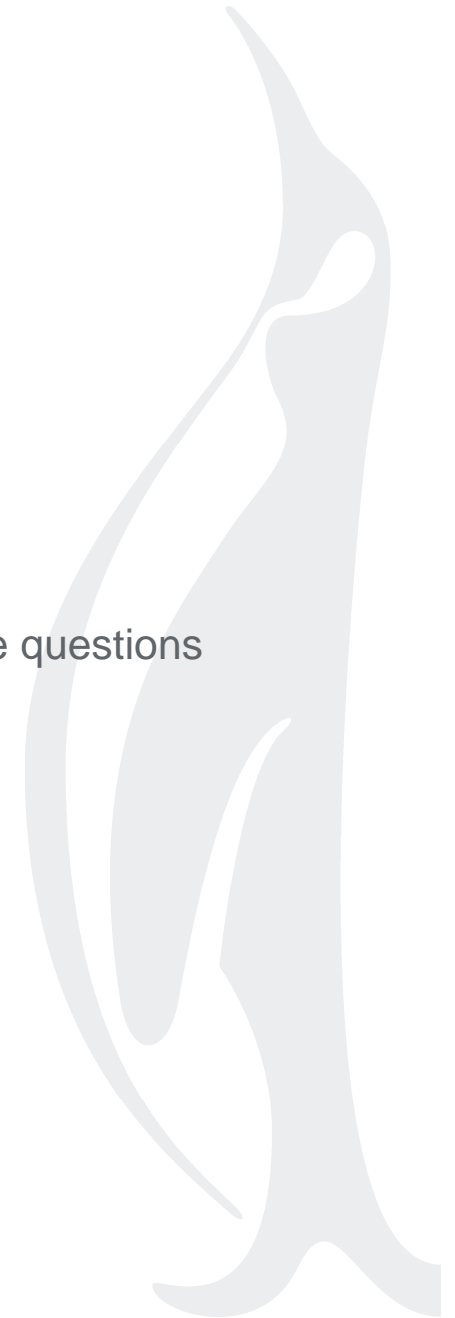
What about emerging managers?

- The lifeblood of the industry...
- ...and (perhaps) the stars of tomorrow
- For investors, some important attractions
 - ▶ Reduce crowding into popular managers
 - ▶ Capacity
 - ▶ Niche opportunities
 - ▶ Economic benefits in some cases
- But also risks to be aware of
- Case Study: CatCo
 - ▶ ILS fund seeded in Jan 2011
 - ▶ Strong opportunity set and a talented team
 - ▶ Strong growth in AUM so far



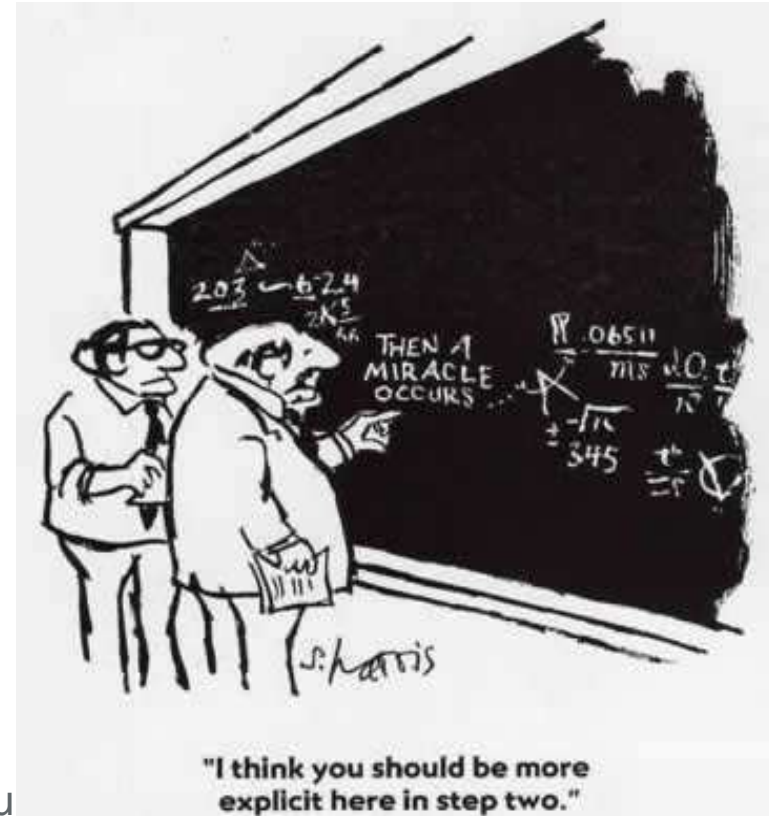
Some words of wisdom

- Know your customer and their rationale
- Example: Pension funds
 - ▶ Assets and liabilities that need to be run together
 - ▶ A simple goal: run down your liabilities faster than your assets
 - ▶ Avoid catastrophic losses though the taking of unintended risks
- Understand that good due diligence fundamentally comes down to three simple questions
 - ▶ How do make money?
 - ▶ Why do you make money?
 - ▶ How do you avoid losing money?
- Understand you are running a business
 - ▶ Match your assets and liabilities
 - ▶ Understand all the risks you face, not just the big ones



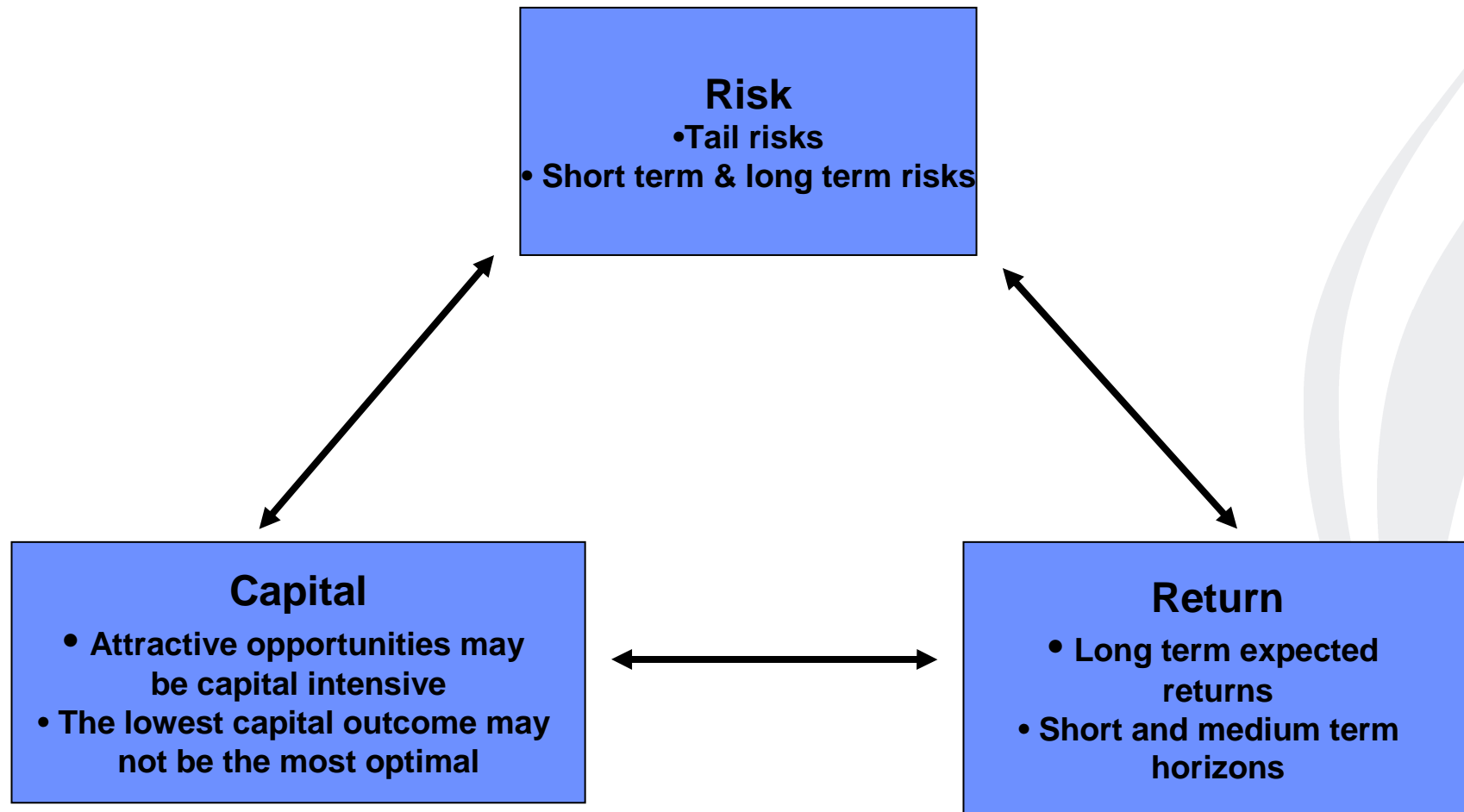
Our approach: always watch the downside

- Risk drives returns
- Only take risk when there is a commensurate expected return
- Risk is a dynamic entity
 - ▶ Changing markets means changing risks
- Many hidden risks
 - ▶ Market risk
 - ▶ Counterparty risk
 - ▶ Interest rates and inflation
 - ▶ Operational risk
 - ▶ Regulatory risk
- Know them all and focus only on accepting risks you understand
- Actively manage and hedge out the rest



Dynamic approach to portfolio management

- Good portfolio construction is a constant trade-off between risk, return and capital employed



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