friday view

Cheek's Week – Staying on the shelf

Madeline Forrester - Is bigger better?

John Mayr - IBOR: a necessity for the new normal

Valentijn van Nieuwenhuijzen- Revenge of the nerds

Mike McEachern - Bond investing: a more flexible approach

By Sebastian Cheek

Back in May the industry breathed a collective sigh of relief when EU Commissioner Michel Barnier announced the Commission would not include proposals to introduce new solvency rules for pension schemes in the new Directive on Institutions for Occupational Retirement Provision (IORP directive).

Great news for pension schemes, but it is worth noting that the proposals were only 'shelved'. As Barnier went on to say it will become a task for the next commissioner taking office in November 2014, presumably meaning the Commission still wants to see a level playing field for schemes across the EU.

But there are two conflicting messages coming out of the EU because there is also an EU Green Paper currently doing the rounds on long-term financing, which says: "The capacity of the economy to make such long-term financing available depends on the ability of the financial system to channel the savings of governments, corporates and households effectively and efficiently to the right users and uses. This can be carried out by various intermediaries (e.g. banks, insurers and pension funds) and by direct access to capital markets."

The paper is effectively urging institutions to be long-term investors, but the Commission is also saying long-dated asset classes such as infrastructure would rate as risky on the 'holistic balance sheet'.

Investors would be forgiven for feeling confused at this juncture and will be inclined to say "thanks, but no thanks" when confronted with asset classes such as infrastructure when in fact they should be making the most of the illiquidity premium as long-term investors – especially with banks unwinding their balance sheets.

Incidentally, JP Morgan Asset Management published research this week saying Solvency II paints infrastructure with too broad a brush and misses an opportunity to distinguish between the diverse styles of infrastructure investing that carry very different expected risk/return profiles.

Quite right. The bigger issue for the Commission is surely the fact that 60% of the EU population have no access to a workplace pension, not whether or not schemes and insurers carry too much risk in their portfolios.

Let's just hope the next European Commission doesn't revive the burdensome capital requirements and that Solvency II remains on the shelf for long enough to get lost under all the dust.

Picture: stockphoto

Is bigger better?

By Madeline Forrester, head of UK institutional, Axa Investment Managers

In the movie 'Big', the main character makes a wish on a carnival game, believing his life would be better if he was bigger. After getting his wish and growing to adult size, he begins to miss elements of his life that could only be enjoyed when he was smaller but had been overlooked in his desire to be big.

This storyline is playing out in the global pension industry, where there is a shift towards consolidation driven by regulatory change and pressure to reduce costs. In Mexico the number of pension funds has decreased from 22 to 12 over the past seven years, while in the UK, the government is assessing the potential for consolidation across Local Government Pension Schemes.

However, is big better? Do bigger funds earn higher returns, if they pay lower fees? What is the impact of size on risk management and risk tolerance?

The return benefit for larger pension funds comes from their ability to get direct access to asset classes and investment opportunities that are not available to smaller funds, for example private equity, catastrophe bonds or infrastructure. However, large pension funds can become too big to fulfil target allocations in alternatives, and can also experience performance drag in traditional asset classes, when the size of their trades gets too large to allow for efficient execution.

Small funds have the option to use multi-asset or fund of fund solutions to delegate asset allocation and due diligence, but these present their own challenges, with lack of transparency, inflexible allocators and an additional layer of management fees. A group of small investors could overcome these challenges through collaboration or by pooling their investments and resources and directly co-investing in solutions that meet their common investment objectives.

It is often assumed that bigger funds are charged lower fees, but this generalisation needs challenging. In addition, more complex structures like performance based fees, instrument based charging and fees based on liability values make it difficult for funds considering consolidation to assess the cost reductions that might be realised post-merger.

To leverage the cost savings that come with size, without pursuing formal consolidation, small funds can take proactive steps. These include ensuring a fee quote reflects the potential for future asset growth, confirming the fee schedule reflects all relationships a pension fund and its sponsor has with a manager, and considering partnering with funds to negotiate a collective fee agreement or create a common investment fund.

While size of a pension fund may unlock access to different strategies, new risks unique to large investors can be introduced. For example, the capacity for banks to transact large derivative trades has declined, suggesting that there is a point when pension funds become 'too big' to implement interest rate and inflation hedging at the times and pace they may wish.

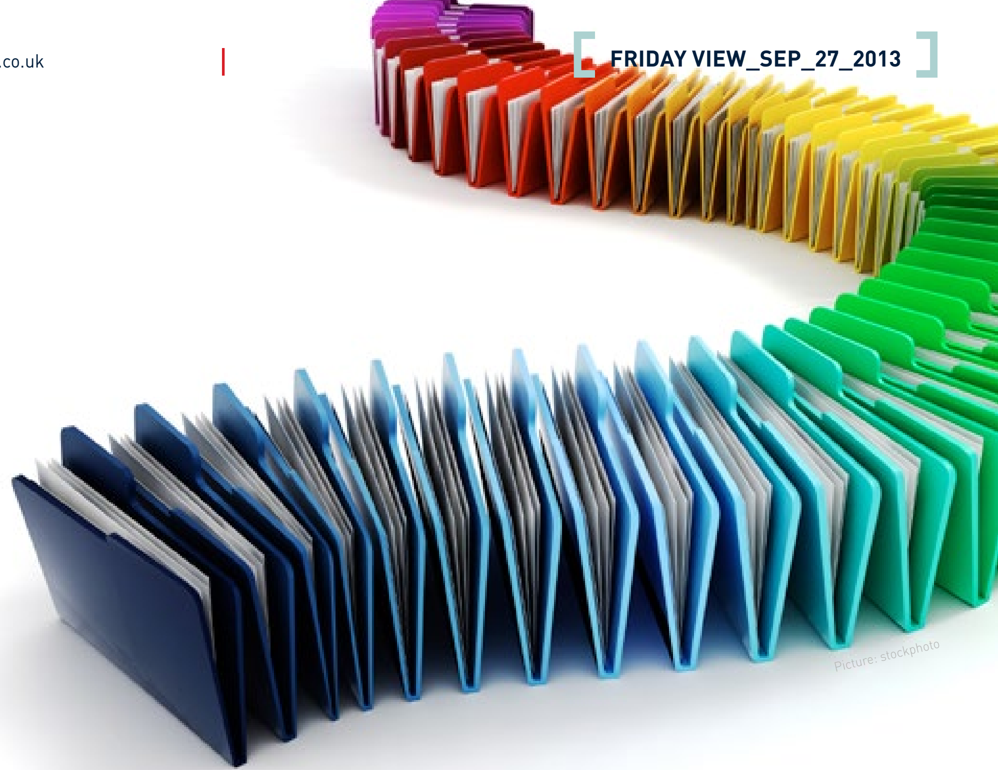
Meanwhile, pooled fund structures that spread the costs of administration and ongoing management across investors have opened up derivatives to smaller funds.

The short answer to the question, 'is big better?', would be 'not always'. Collaboration rather than consolidation might allow small funds to capture some of the benefits of being bigger without giving up their flexibility or agility.

So for smaller pension funds that discover an old carnival game that promises to make their wishes come true, perhaps instead of wishing to be big, they should wish to find other funds willing to work alongside them to produce superior results.

portfolio institutional

IBOR: a necessity for the new normal



Picture: stockphoto

By John Mayr, marketing and partner development, SimCorp.

This September marks the fifth anniversary of the collapse of Lehman Brothers. Half a decade later the asset management industry is still adapting to the events of that autumn, which represented a turning point in the industry's approach to risk management.

One of the issues the bankruptcy highlighted was the disparity between different firms' capability to ascertain their counterparty exposure to the failed bank. Some took days or even weeks to complete this process, which amid severe market volatility and demands for information from panicked investors, was plainly insufficient.

As the financial crisis unfolded, this paucity of timely, accurate data about every part of an investment manager's risk exposure has come to represent a more significant problem for a number of reasons. Despite its importance, accessing it quickly and easily is still not straightforward for many firms. This is because recording trading information and position keeping have historically been fragmented processes within investment managers, with front, middle and back offices often operating separate systems. To complicate matters further, some functions are handled by outsourced providers which generally feed in data in non-standardised formats.

This process has usually been underpinned by what is today referred to as a Trading Book of Record (TBOR) and a separate Accounting Book of Record (ABOR). TBOR, as suggested by the name, holds information on front office trading activities, recorded as they happen and building on start of day positions uploaded from the ABOR each morning. Overnight, the ABOR takes the end of day TBOR and supplements it with further data from those other disparate systems – data on corporate actions, collateral movements, derivatives resets and so on.

So, throughout the day the TBOR and ABOR are out of sync: neither offers a full and comprehensive view of positions nor, consequently, risk exposure.

What is required is not a TBOR or ABOR, but an Investment Book of Record (IBOR). IBOR integrates multiple sources of data to provide an automated, timely, comprehensive overview. It incorporates both trading and non-trading information that nevertheless affects investment positions, combining the functions of both the TBOR and ABOR. It synchronises data from the front, middle and back office, including from outsourced providers (if they can provide it intra-day), to present a single version of the truth. As trading and other events evolve intra-day, the IBOR gives investment managers a significantly fuller picture of their positions and a much better understanding of risk.

The Lehman Brothers collapse marked a tipping point from which the IBOR became an essential tool for robust risk management – and not just for purposes of assessing counterparty exposure, but as a result of the wholesale shift in nearly every aspect of the investment environment. Ongoing market volatility, for example, means it's imperative for investment managers to possess an up-to-the minute picture of their positions and forecasts to make well-informed decisions.

In addition, new financial market regulations, such as Dodd-Frank, MIFID, EMIR and Solvency II, demand increased reporting to both clients and relevant authorities. It is simply too resource intensive and time consuming to have to pull this information from several different sources with no guarantee of accuracy or completeness. Central counterparty clearing (CCP) for derivatives, for example, has introduced much more demanding requirements for collateral management, which alter asset managers' cash and securities positions, current and forecasted, intra-day. An IBOR will reflect these.

In general terms, there is an overall shift in regulation towards implementing a full and timely overview of risk. Rather than attempting to comply with each individual piece of regulation with a separate solution, implementing an integrated approach to risk management will give investment managers greater oversight helping to pre-empt regulatory requirements in this area.

The IBOR is the most efficient solution, not only to comply with this regulatory impetus, but for asset managers to meet the challenges of the "new normal."

portfolio institutional

Revenge of the nerds

By Valentijn van Nieuwenhuijzen, head of strategy, ING Investment Management

Investors were able to enjoy their summer holiday this year without losing too much sleep. Of course, that wasn't to say that nothing has happened on the markets. In fact, we see some interesting developments that have created the opportunity to add some notable underperformers of the past few years to the portfolio.

In contrast to previous years, the markets have been sailing in calmer waters this summer. Last July, ECB president Mario Draghi was making waves with his now famous "whatever it takes" speech to stave off the growing euro crisis. Since then, equity and bond markets have been characterised by a period of relative calm and strong performances. In May, Fed president Bernanke threatened to throw a spanner in the works after announcing that the central bank would start to wind down its highly accommodative monetary policy in the short term. In the wake of some reassuring words from central bankers and growing evidence of a recovery in the developed economies, the panic died down and markets entered smoother waters. Thanks to strong economic figures and pledges by central banks to keep interest rates "low for longer", the market outlook for the coming months looks favourable.

Equity markets are showing the most promising prospects. Following the "search for yield" in all corners of the financial markets that has been so typical of the past few years – and which led to a huge increase in investor interest for bonds – investors are climbing ever higher on the risk curve. More and more, (institutional) investors are setting their sights on stocks, especially now that the economic figures for the developed economies are clearly improving. This is strikingly demonstrated by the fact that flows to equity funds have now surpassed those in the direction of bond funds for the first time since 2007 and this is a trend which has continued with even greater intensity over the last few weeks. The inflow in bond funds is only moderate and – not coincidentally – concentrated in high yield: bonds with marked equity-like characteristics.

Picture: stockphoto

In an environment of accelerating economic growth, cyclical stocks thrive best. While sectors such as consumer discretionary and industrials have been performing well for some time, it now looks as though commodities and related stocks are making a comeback, too. Commodities have lagged behind substantially during the search-for-yield period, given the fact they earn you no 'carry'. A prolonged recovery in the global economy and especially the better than expected figures reported for China in July provide support. Year-to-date, the materials sector has underperformed the MSCI World by almost 20% and is, with the exception of utilities, the most unloved sector among investors. The sector can expect a strong upturn in earnings growth thanks to the improved prospects for the global economy.

As far as the regions are concerned, things are starting to look up for Europe. For obvious reasons, European shares have been unloved in the past years. This has resulted in a discount of around 35% compared with US equities, which now occupy the largest overweight position in the portfolios of institutional investors in 10 years. Now that European economic data are clearly improving – and the eurozone is showing growth again for the first time in six quarters – the tide seems to be turning for European equities. Investors have put the systemic risk of the eurozone onto the back burner, while the recovery of the European economy is being bolstered by persistently accommodative monetary policy, a declining fiscal drag and an increase in global growth.

The day has now dawned that investors are shifting their faith from yield to value in the market. In the first instance, this will favour equities. At a subordinate level, those regions and sectors which have clearly underperformed over the last few years are making a comeback. Revenge of the nerds!

portfolio institutional

Bond investing: a more flexible approach

By Mike McEachern, portfolio manager, Muzinich & Co.

Fixed income investing may be reaching an inflection point: markets are jittery about US quantitative easing ending and with ultra-loose monetary policy from the Fed no longer to be relied upon we could be looking at the end of the 30-year bull market fixed income investors have enjoyed amid long-term falling interest rates.

Against this backdrop, many investors are looking beyond traditional long-only strategies to flexible solutions designed to perform during different market conditions and deliver meaningful return during periods of rising interest rates. The hedge fund world has long been home to flexible, absolute return approaches to credit investing which are free from benchmark and sector constraints and now their appeal is growing, giving rise to a newer breed of strategies where performance fees and leverage are absent and more robust risk controls and regulatory frameworks present.

Key features of next generation credit

A good multi-asset credit portfolio should be able to generate returns from a wider number of sources than a traditional strategy, using a range of techniques to capture attractive risk-adjusted returns, avoid out-of-favour sectors, dampen volatility and hedge risk. The absence of standard benchmarks is crucial because they carry interest rate sensitivity by being tied to duration parameters. Removing these gives managers greater flexibility to control interest rate risk and boost returns by allocating to less duration-sensitive assets.

Benchmark-free managers are also more able to navigate between credit sectors; the dispersion of returns from major fixed income indices globally underlines how being tied to one or two markets may hamper return potential. European high yield went from being the worst-performing fixed income asset class in 2011 to the best in 2012.

However, this wider scope risks investment managers dabbling in sectors where they lack expertise. The global behemoths may be resourced to cover the entire credit universe, but boutiques should focus on where they can add the most value. In our case, by tactically allocating between global credit markets we can fully leverage the proprietary, in-depth, bottom-up research which underpins all of our credit selection and fulfil our investment and risk tolerance targets without needing to consider assets where we do not have the same high level of expertise.

Hedging

Hedging is important to many global multi-asset credit strategies, creating opportunities to bolster returns through shorting or to dampen volatility and neutralise market beta ultimately improving risk-adjusted and absolute returns.

Growing demand for more nimble, multi-asset fixed income strategies does pose some problems for investors, such as how to evaluate an investment with no benchmark. The simplest way to do this is to assess whether the strategy delivers on its investment goals, typically X percentage points above the risk-free rate, within stated risk parameters. For our next-generation strategy, Global Tactical Credit, we are targeting Libor plus 5-7% while also protecting capital in weak or falling markets.

Institutional investors are also puzzling over where multi-asset credit strategies fit into their overall fixed income allocations. At one end of the spectrum they can be seen as anchors around which a portfolio can be built, or even a one-stop-shop for global credit exposure that obviates the need for portfolio-level asset allocation; at the other end, those with a more active approach may view multi-asset credit as a component of a wider fixed income allocation designed to enhance overall portfolio returns and reduce volatility. This versatility is really a testament to just how precisely tailored multi-asset credit strategies can be.

How investors will deploy multi-asset credit strategies remains to be seen, but the big question is whether these strategies will deliver? We believe that with the right investment manager and strategy they can and that next generation multi-asset credit solutions will play an increasingly integral part in fixed income portfolios moving forward.

Have a nice weekend.

portfolio institutional is on twitter, follow us @portfolio_inst

Publisher
portfolio Verlag
Suite 1220 - 12th floor
Broadgate Tower
20 Primrose Street
London EC2A 2EW

Tel: +44 (0)20 7596 2875
Fax: +44 (0)20 7688 9118
E-Mail: london@portfolio-verlag.com

Editor
Chris Panteli
E-Mail: c.panteli@portfolio-verlag.com

portfolio institutional