

Raising the game to meet liabilities

Investment banks and asset managers need to replicate parts of each others' business, argues Richard Tomlinson



TALKING HEAD

Will the European pension problem be solved in 2006? I'd say not, but perhaps if individuals begin to take more responsibility for their pensions, and the fund management industry changes its approach to the way assets are invested, we may be able to make a good start.

In spite of a further recovery in the value of assets during 2005, the shortfall among FTSE 100 company schemes is estimated to have risen by 10-20 per cent. With defined benefit schemes accounting for about £800bn (€1,165bn) of assets, investment consultants and asset managers continue to look for innovative solutions to the rising deficit problem. At the heart of this is a need to focus on controlling risk, rather than simply generating returns.

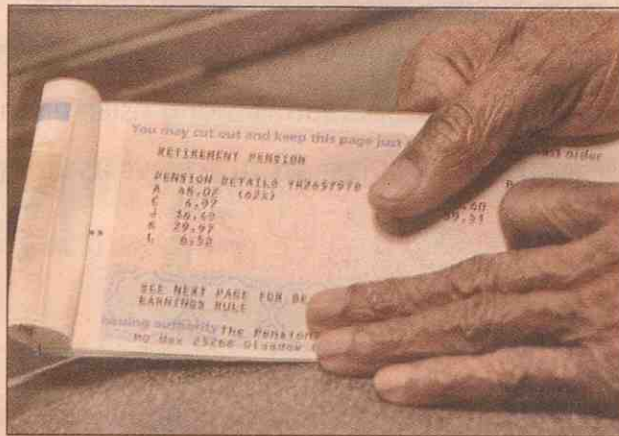
The changes in the occupational pensions industry will continue to drive the greater use of derivatives, hedging strategies and liability driven investments, which will mean increasing sophistication.

Much of this change is

being driven by an increasing desire, and in many cases requirement, to increase the statistical confidence that can be attached to likely investment outcomes. At its simplest, the expected outcome for a cash portfolio is more certain than for one made up of gilts, which is more certain than a pure equity portfolio. Moving exposure from equities into bonds is one way of achieving increased certainty but there are more appropriate options.

In a traditional "directional" pension portfolio, managers sought to reduce risk, and therefore increase certainty, by increasing exposure to bonds. The realisation that this strategy proved to be less efficient in generating significant alpha led to the increasing use of derivatives as a risk management tool. Modern managers now appear to be moving away from the static model and are adopting a more dynamic, efficient approach, enabling them to react more quickly to changing funding levels, interest rates and asset price volatility.

Although I expect bonds to continue to play an important role in the management of risk, they are no longer the only tool in the manager's box. Managers will increasingly use derivatives such as swaps and options to



The use of liability driven investment should help pension managers conduct risk management provision more effectively Getty Images

hedge against changes in levels of interest rates and inflation – although as yet managers have no capability to hedge against mortality risk, which remains a key challenge, given the impact that mortality changes have had on liabilities.

Additionally, consultants are requiring managers to provide pension solutions that separate assets that provide increased anticipated returns from those that provide risk control. This is principally being achieved through synthetic financial instruments – liability driven investment (LDI).

While only a fraction of the £800bn in DB funds is managed on a LDI basis, the signs point towards the floodgates opening this year.

Within LDI, I also expect an increase in the use of absolute return strategies such as hedge funds and structured products.

Structured products, often based on an underlying portfolio of hedge funds, offer the advantage of being able to be tailored to meet objectives of growth and protection, thereby offering different levels of exposure to upside potential and downside protection.

Increasingly, schemes will need to move towards strategies that more closely align a portfolio's sensitivity to changes in market factors, such as long-term interest rates, maintaining the ability of its assets to meet its liabilities. The use of LDI enables managers to target

the same levels of risk and return, while ensuring risk management is conducted in a more effective way.

An increased use of derivative strategies in pensions fund management seems inevitable. In 2006, the rise in these strategies, such as a DB scheme executing a combination of interest rate and inflation swaps to better align its assets with its liabilities, is likely to go hand-in-hand with an increasing separation of alpha from beta. Alpha managers will focus on the extraction of risk premia from individual assets, while beta managers focus on providing diversified and efficient market exposure.

Employing innovative strategies, such as those associated with LDI, could go a long way towards meeting the rising liabilities that the industry faces. In delivering these solutions to investors the traditional activities of asset managers and investment banks will continue to become blurred, with both sides needing to assimilate thinking and practices from the other. In a sense, asset managers will have to think like bankers and vice versa.

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