AN ALTERNATE ANALYSIS

Pension funds are piqued by some alternatives, wary of others.

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The subject of alternative investments has been getting a lot of air time in the pension world for a few years now. Are Canadian pension funds just talking, or are they actually investing in these areas? Are Canadian institutional managers standing idly by as alternatives threaten to take away their share of the pension investment market, or are they taking action?

In order to answer the first question we reviewed the allocations large pension plans have made to alternative asset classes, looking at their allocations as at December 31, 2002, and changes to those allocations since June 30, 2000. As at December 31, 2002, we had information on the 79 pension funds in Canada with assets over $1 billion and we had comparative data (i.e., both June 30, 2000, and December 31, 2002, data) for 39 of Canada's 50 largest plans. For the purposes of our analysis, we broadly defined "alternative" asset classes to be anything other than publicly traded, developed market stocks and bonds.

We noted the following:

• Real estate, mortgages and private equity are not really very alternative for large Canadian pension funds. As at December 31, 2002, 82% of funds had an allocation to at least one of those classes and 27% were invested in all three.

• Exposure to hedge funds is still low, but growing rapidly. Only 11% of plans were invested in these vehicles as at December 31, 2002, although most of those plans were not invested in this area at all as at June 30, 2000. Also, the median hedge fund allocation for those plans was 7%, indicating that where plans have made the decision to invest in hedge funds, they are taking meaningful positions.

• With the exception of foreign bonds, all alternative investment categories reviewed enjoyed net positive investment flows (i.e., both a net increase in the number of plans exposed to each category and an increased average allocation to each category) between June 30, 2000, and December 31, 2002. Foreign bonds saw a slightly negative investment flow over that time period. The biggest beneficiaries of these positive investment flows have been emerging market equities, private equity, real estate and hedge funds.

• Although increasing numbers of Canadian pension plans are becoming exposed to alternative asset classes, allocations remain low. As at December 31, 2002, the average exposure of plans that have invested is below 5% for all alternative asset classes (except hedge funds at 7%) indicating that pension plans are using alternatives to complement, rather than replace, traditional asset classes.

To get a sense of how traditional Canadian money managers are reacting to pension plans' increased interest in alternatives, we surveyed 25 of the largest non-captive institutional fund managers in Canada regarding their alternative product offerings as at September 30, 2003. We found that:

• The large majority (88%) of these managers already offer products in at least one of the following alternative areas: real estate (32%), emerging markets equity (48%), high yield bonds (60%), foreign bonds (48%) and hedge funds (48%).

• In most cases, these alternative products have been offered for at least two years. Although, in the case of hedge funds, one half of the available products were only launched in the last two years.

• Canadian managers are rapidly developing new alternative investment products, with hedge funds being the most popular area for new product development.

In summary, the exposure of large Canadian pension plans to alternative investments is already widespread in some areas (e.g., real estate, mortgages, private equity) and is growing in others (e.g., hedge funds). So far, allocations are still small, but this is changing rapidly: Canadian institutional managers have certainly taken note, and development of new products is progressing at a feverish pace. Alternative investments may not be mainstream yet, but if the recent pace of change continues we may soon have to drop the "alternative" label. ▮