



# A CONVERT TO ALTERNATIVES

*Necessity is the mother of alternative allocation.*

Why would a career generalist turn to alternative strategies? Simply out of necessity, driven by a view of dramatically different dynamics in the years ahead.

Financial markets are poised at a major inflection point. The 24-year tailwind of falling interest rates has been the dominant force in generating anomalous conditions characterized by double-digit returns: stocks and bonds alike are highly positively correlated, given their common driver. This persistent trend has shaped mainstream investment practice in many ways: high returns allowed plan sponsors to focus primarily on the asset side of the pension balance sheet, the industry evolved to static policy portfolios populated by narrow style-defined mandates, and plans are dominated by their market or beta exposure while most of the active risk or alpha has been squeezed out. What does the future hold? Lower returns for sure: perhaps 4% on bonds and 7% on equities with a propensity toward negative correlation driven more by the business cycle.

Within this new environment, both defined benefit and defined contribution plans will have similar needs: risk management takes on new significance. Low base returns will place a greater premium on managing absolute downside, while risk budgeting will become the dominant framework in managing plans. Any hope of meeting return targets will require pushing the policy envelope: assuming more active risk, eliminating the long-only constraint, and increasing exposure to alternative strategies. Pension plans must build in more flexibility, and dynamic asset allocation strategies—discredited in the high-correlation environment of the past 25 years—have significant potential to enhance returns and reduce risk. Funds will need more alpha, which requires assumption of more active risk. Longer investment horizons, a long-underrated and underutilized advantage of pension funds, will be required to allow alpha strategies to develop.

Implementing new strategies will be a challenge for the average plan, but even limited applications of alternative strategies in an asset/liability framework

can be useful in making the evolution to a more effective structure, as can maintaining an open mind. Consider the case of a plan sponsor that decided to move away from a heavily equity-oriented strategy, eliminate market risk, and immunize liabilities with a fixed income strategy: while they were resigned to a low-return dedicated bond portfolio, they still had an appetite for risk and were reluctant to give up the consistent alpha generated by their equity managers. There is a relatively simple solution which allows retention of their equity managers while swapping the underlying equity exposure for the fixed income duration needed to hedge their liability.

**“FUNDS WILL NEED MORE ALPHA, WHICH REQUIRES ASSUMPTION OF MORE ACTIVE RISK.”**

How do we give the average mid-sized plan easy access to these strategies? Ironically, traditional managers will likely play an important role in delivering them. We will also likely see the renaissance of the balanced fund manager as someone who operates in an overall coordination role—sourcing beta, integrating the overall structure in a risk management framework, and taking on the aggregate risk management of a plan—ultimately providing the average plan with the kind of resources that top funds in Canada already have. A fund-of-funds structure is the most practical method of delivering alternatives to the typical plan. These must be more deliberately designed to deliver an expanded opportunity set of diversified and uncorrelated alpha generators while having easily identified risk exposures to permit integration into the overall risk budget of a given plan.

To paraphrase Plato, “necessity is the mother of adoption.” Necessity has brought us to this point, and to these alternatives: our next challenge is to take them mainstream. ■