# THE INS AND OUTS OF ALPHA

*A pension fund perspective on alternative investments.*

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In the pension fund world, bonds are useful for hedging liabilities but the equity markets are used to generate higher returns. Plan sponsors typically take on a high proportion of equity risk to reduce the cost of financing their plans. On the other hand, if sponsors were to include more bonds in their portfolios, they might be able to reduce risk, but this will also increase the cost of running their plan.

An alternative investment, ideally, will provide the necessary interest rate sensitivity to hedge the liabilities. At the same time, it will generate a higher return than bonds without increasing equity market risk. The question is, will any of the four alternatives currently being offered (real estate, high yield bonds, private equity and hedge funds) meet this need?

Let's start by looking at real estate. It is an ideal alternative to equities because of the low volatility of returns, but the fact that its values are linked to interest rates gives real estate a loose and bond-like characteristic. There are a few open-ended pooled funds available in Canada, but these could run into problems if falling returns cause less patient investors to pull out, forcing the funds to sell their properties in a falling market. Funds that hold publicly traded real estate, REITS or stocks of corporations that derive their value from real estate, don't have this problem. However, the volatility of their returns is similar to other publicly traded equities and, while such funds may be useful for diversifying a fund's equity portfolio, they are no substitute for directly held real estate.

At first blush, high yield bonds may seem like a great investment for a pension fund. Look closer, however, and you'll find their duration is usually too short to be helpful in matching a pension fund's liability. Furthermore, the price of these bonds is driven by the market's perception of the issuer's credit and prospects. Unfortunately, this market view is the same as the equity market's view and, as such, the return on high yield bonds has been highly correlated to small-cap equities. Ultimately, such bonds are only useful for diversifying the fund's equity portfolio.

Private equity is becoming more accessible with the creation of pooled funds that provide a diversified portfolio of limited partnerships; however, all of these funds rely on the public equity markets for their exit strategies and their returns are ultimately correlated to those markets. Again, like high yield bonds, these investments are useful for diversification, but that's all.

Investment in hedge funds in Canada has so far been generally restricted to the largest pension funds and those who understand how they work. Others often lump all hedge funds together and discuss them as if they were a homogeneous group. In fact, there are many different hedge fund trading strategies, each with different return patterns and risk characteristics.

Hedge funds that trade in equities vary in the degree of market risk they hedge. Those that hedge most of it away (equity market neutral funds) have shown not only a very low correlation with equities but a remarkably low volatility as well. Recent returns of equity market neutral hedge fund indexes have been in the low single digits and, because of this, one might dismiss market neutral funds as being of no use. However, the extremely low volatility of their returns, when pooled together in a fund of funds, makes them an ideal candidate, like real estate, for leverage.

**NOWADAYS, IT IS MORE POLITIC TO REFER TO LEVERAGE AS PORTABLE ALPHA.**

Nowadays, it is more politic to refer to leverage as portable alpha and this is where pension funds should be focusing their attention. By porting the alpha of a low volatility fund of hedge funds on top of a portfolio of long-term bonds, a plan can create the ideal pension fund investment, one with the sensitivity to interest rates that can match the plan's liabilities and also the added returns necessary to reduce the cost of the plan. ■