

# Going Back to Basics by John Redwood

Trustees faced with making difficult portfolio decisions will need help and guidance if they choose to follow actuarial advice and invest more heavily in bonds

Trustees are counting the costs of staying fully invested during this downturn. Actuaries are sucking their pencils and saying: 'You would have been better off in bonds.' For once, they have been right. Meanwhile, the liability-driven (LDI) investment salesmen are out in force, with new proposals to add to the complexity of your portfolio.

I like to try to keep investment simpler. It's difficult enough deciding whether to be in equities or bonds or cash, or what mixture of the three. If you make good judgments about that, you can look after your fund and pay future pensions. It was not that difficult to grasp that 2008 was the year to be very cautious and to keep or create a lot of cash. We may soon be able to make some money in corporate bonds, locking in good yields on company paper where the underlying company will survive.

Trustees are often left with the responsibility of settling the asset allocation. This high-level decision will be the main determinant of how well or badly their fund performs. It is a decision that needs proper attention.

### **Overlay is overrated**

I cannot see the advantage of some types of LDI. The other day I was taken through an interest rate overlay. The story goes to the trustees that they cannot match their liabilities by a bond portfolio, because there are not enough very long bonds. That is true. The success in matching depends entirely on what future interest rates happen to be, as much of the return comes from reinvesting the income and replacing the shorter duration bonds at good yields.

Indeed, you could add that it is difficult to understand why intelligent people should ever think that bonds can match pension liabilities. Fixed income bonds pay a fixed income. Pension liabilities rise as incomes rise, as inflation rises and as people live longer. In the words of the actuary, a pension fund has a longevity risk, an inflation risk and an interest rate risk. In normal times – and today is not a normal time – equity and property are more likely to match pension liabilities, because they experience rising income rising faster than inflation, and even faster than wages.

So how does the interest rate overlay work? It's done through swaps, one of the proliferation of structured instruments that have caused so much trouble in the investment banking world over the last year. Effectively, the pension fund places a bet with a bank or other counterparty, that interest rates will fall. If they do, the counterparty pays the pension fund money to compensate. If they rise, the pension fund has to pay money out, as it has lost the bet. Some of these bets are open-ended, so

if interest rates rose a lot the fund would lose a lot. The fund also has to pay fees to those who do the arranging and managing.

The truth is that such an overlay does not solve the underlying problem. Ordinary bonds do not and cannot accurately match pension liabilities. Pension funds need to cover rising wages and people living longer. That needs growth in cash flows, which either come from growth in the assets of the fund or from growth in the company sponsoring the fund and its contributions.

It is true that the older a fund gets and the nearer to final payout and maturity, the easier it is to get close to your annual cash needs by choosing bonds. It is also true that in a fund in wind-up, index-linked bonds may be able to match liabilities more closely, if pensions are linked to prices and not to earnings, and if longevity is stable. Of course an investment manager needs to work with an actuary and try to get the best possible balance of investment risk against cash needs.

### **Have alternatives had their day?**

A couple of years ago alternative investments were all the rage. Items like property, commodities and hedge funds were said to be uncorrelated – they were thought to move differently from shares and in some cases to offer better returns at lower risks. Last year showed that most of these come crashing down in falling markets as well. Most of them depended on the very same easy credit and easy money that had powered share markets to higher levels.

Their time will come again in some cases. Property worked very well for UK pension funds for many years until 2007-2008. When property values have adjusted and we can look forward again to rising rentals, this asset class has much to offer. Similarly commodities, if managed on a conservative basis without gearing or borrowing, can be a good store of value when the world economy is growing again.

### **Losing the magic**

There is, however, no magic box solution based on bonds or swaps. Paying pensions will always depend on a combination of a successful company paying money into the fund, and a successful investment strategy for a fund. If you can keep the value of your assets in difficult times like 2008 by being cautious, you can then improve your returns in normal times by buying claims on real assets, where the income rises more in line with your liabilities.

This year may well be a year of opportunity for funds to acquire some claims on real assets that will once again offer rising income from good starting yields. Trustees do need strategic investment advice. There is no shortcut.

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