Agenda No

AGENDA MANAGEMENT SHEET

Name of Committee	**Pension Fund Investment Board**
Date of Committee	**17 February 2006**
Report Title	**Alternative Investments**
Summary	Report setting out the options available to the Pension Fund with regard to investment of the Pension Fund in alternative investments, namely, property, private equity, hedge funds and commodities.
For further information please contact:	Phil Triggs Group Accountant Tel: 01926 412227 philtriggs@warwickshire.gov.uk
Would the recommended decision be contrary to the Budget and Policy Framework?	No.
Background papers	

CONSULTATION ALREADY UNDERTAKEN:- Details to be specified

Other Committees	☐	....
Local Member(s)	☐	…………………………………….
Other Elected Members	☒	Cllr Davis, Chair of Pension Fund Board
Cabinet Member	☐	…………………………………….
Chief Executive	☐	....
Legal	☒	Jane Pollard, Assistant County Solicitor, Catherine Witham, Senior Solicitor
Finance	☒	David Clarke, Strategic Director of Resources – reporting officer
Other Chief Officers	☐	....

District Councils	☐	....
Health Authority	☐	....
Police	☐	....
Other Bodies/Individuals	☐	....

FINAL DECISION YES

SUGGESTED NEXT STEPS:		Details to be specified
Further consideration by this Committee	☐	....
To Council	☐	....
To Cabinet	☐	....
To an O & S Committee	☐	....
To an Area Committee	☐	....
Further Consultation	☐	....

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Pension Fund Investment Board – 17 February 2006

Alternative Investments

Report of the Strategic Director of Resources

Recommendation

That the Board note the report and decide on a way forward with regard investment in these investment categories.

1 Introduction

1.1 Warwickshire County Council Pension Fund currently takes the ‘traditional’ approach with regard to asset allocation of its Pension Fund. Funds are invested in equities, government gilts, non-government bonds, with a small percentage in cash.

1.2 Board members recently discussed the possibility of investing in local newly constructed property. Exposure to various forms of alternative investments can assist in the restoration of funding deficits and the achievement of desired returns.

1.3 The Board requested that a report covering the whole spectrum of alternative investments be put to the Board and this report will detail the alternative investments that are available.

2 Features of Alternative Investments

2.1 Alternative investments are not precisely defined and they are regarded as a non-core asset class with such typical features as:

- Illiquidity;
- Non transparency;
- Reliance on manager skill to extract acceptable performance;
- Management fees toward the higher end;
- Investment returns unrelated to the equity markets.

2.2 Allocations to alternatives are typically small and funds would usually set a maximum proportion of the fund available to alternatives and then identify a range of alternatives to be allocated from within this proportion.

2.3 Alternative investments comprise of property, private equity, hedge funds and commodities.

3 Property

3.1 Property is regarded as the best performer in recent years, especially over the last ten-year period. It is traditionally seen as an "inflation hedge" and a valid alternative to fixed income investments.

3.2 Property is placed between equities and bonds in terms of both risk and return. It is an asset class that performs well at different times of the economic cycle when compared with equities and bonds.

3.3 Property yields are not directly comparable with bonds but its long-term returns are expected to be ahead of inflation and earnings.

3.4 One important factor to remember is the high level of transaction costs, typically between 6% and 8%. Also, yields are not fixed (like bonds because of voids (vacant property) and possible rental reductions.

3.5 Finally, it should be remembered that property is subject to illiquidity, i.e., it is not possible to quickly 'cash in' as is the case with equities and bonds.

4 Private Equity

4.1 Private Equity can be defined as the investment in the stock of a company that is privately owned. Thus, the stock is subject to private ownership rather than being publicly listed.

4.2 Valuations of private equity investments are subjectively appraisal based rather than subject to market led pricing.

4.3 Once the investment is committed, it becomes relatively illiquid as opposed to the ease of trading associated with other asset categories.

4.4 Private Equity companies actively seek to add value in their companies before floating them on the market. There is thus potential for higher investment returns than with quoted stocks, although there is a much higher risk associated with the return.

4.5 The range of returns varies considerably and therefore average performance is not worthwhile measuring. These are very much a long-term investment as a result of the cyclical returns.

5 Hedge Funds

5.1 Hedge funds focus on an absolute return. The intention is on achieving a positive return in any market as opposed to achievement of a return "relative to an index".

5.2 The main attraction of hedge funds to investors is to reduce short-term volatility in returns. The main difference from the traditional approach to equities is the manager's ability to short sell, i.e., selling a stock that the manager does not yet own.

5.3 Investment in hedge funds is not necessarily more efficient than equities but there are higher fund manager fees as well as a lack of transparency. Moreover, the investment type is especially illiquid.

5.4 The biggest constraint, however, is the difficulty in finding a skilled hedge fund manager. The best returns from funds depend hugely on manager skill (known in city speak as *alpha*). Investment returns from hedge funds vary enormously.

5.5 The use of a 'fund of funds' is appropriate for pension funds and this enables proper diversification amongst a selection of professional managers. Fees are usually taken on the basis of a percentage of the positive return.

6 Commodities

6.1 Exposure to commodities is achieved typically through "tracking" an index (via derivatives) rather than buying/selling the commodity itself.

6.2 An index of commodity prices measures a return in a broad range of commodity futures contracts.

6.3 Commodities have achieved strong returns over last the last thirty years. Such an investment vehicle has strongly perceived inflation hedging properties.

6.4 There is a low correlation to equities/bonds and oil/energy prices are a big contributor to total returns.

6.5 Index-linked bonds are regarded as a more effective inflation hedge. This is an unusual investment for a local authority pension fund with Bedfordshire County Council recently having exposed its pension fund to this category.

7 Recommendation

7.1 Members are asked to consider the various alternative investment types and agree a way forward. It is recommended that Mercer be requested to supply an investment consultant for the Board's next meeting prior to any decision being taken.

7.2 A comprehensive analysis of the characteristics of the investment types is shown in **Appendix A**.

DAVID CLARKE
Strategic Director of Resources

Shire Hall
Warwick
February 2006

Summary Description of Alternative Assets

	Characteristics	Advantages	Disadvantages
Property	▪ Investment in commercial property, either directly or indirectly through pooled vehicles. ▪ Unit sizes tend to be large leading to pooled investment for many pension funds. ▪ Relatively illiquid asset with high transaction costs. ▪ Performance is derived from rental income plus capital appreciation less running costs (and depreciation/obsolescence). ▪ High Lease to Value ("HLV"): specific area of the market focusing on properties with long leases and high quality tenants. Expected to behave more like a corporate bond.	▪ Offers expected returns in excess of bonds and acts as a portfolio diversifier. ▪ HLV property can provide a valuable source of extra yield relative to bonds, while still providing bond-like stability.	▪ High transaction costs and poor liquidity need to be taken into account in any assessment. ▪ Current availability of quality property is seen to be limited. ▪ Significant inflows over the past few years have seen funds closing in order to invest increasing levels of cash held within them. ▪ Performance subject to assessment of property worth and may understate true volatility if asset were to be sold.

	Characteristics	Advantages	Disadvantages
Commodities	▪ Exposure typically achieved through a commodities index future (i.e., buying and selling the right to a basket of commodities at a specific price and date, with performance then determined by subsequent price movements) rather than buying/selling individual commodities. ▪ Returns highly skewed to the energy sector, and hence oil prices, which accounts for c70% of GSCI^{+} Index. ▪ Supply and demand for raw materials is key return driver. ($^{+}$ Goldman Sachs Commodity Index)	▪ Exposure to a market area which has shown periods of very strong performance ▪ There is an economic rationale for trading in commodity futures to deliver returns *in excess of* the underlying commodity. ▪ Low correlation to equities/bonds offers good diversification potential. ▪ Perceived inflation hedging properties.	▪ Strong recent returns have led to high commodity prices. ▪ Economic rationale for additional return from buying futures has not been witnessed since late 1990s.

	Characteristics	Advantages	Disadvantages
Private Equity	▪ Manager will invest in a range of non-quoted equity type investments, which range from backing new company start-ups through to providing development capital for existing companies and to provide capital for buyouts ▪ Investment is typically through a limited partnership ▪ Typically involves investor making an initial cash commitment, with cash being drawn down in first few years and returns achieved later in the investment's life ▪ Valuations are appraisal based (not market pricing)	▪ Offers potential returns in excess of quoted equity market ▪ Diversification away from quoted equity market risk	▪ Monitoring difficulties ▪ Volatility of returns higher than quoted equities ▪ Reliance on "good" manager with considerable variation between the returns achieved ▪ Difficulties of gaining access to the best funds ▪ Highly illiquid ▪ High fees ▪ Lack of transparency

	Characteristics	Advantages	Disadvantages
Hedge Funds	▪ Not an asset class in itself, or easy to define concisely, they employ a wide range of strategies, e.g., ▪ *Long-short: positive exposure to one stock cancelled by "short" position in another to create a portfolio whose return depends on the relative performance of the two rather than the performance of the overall market* ▪ *Event-driven: e.g., establishing positions to take advantage of merger and acquisition activity.* ▪ *Convertible arbitrage: taking advantage of pricing anomalies between two investments which provide exposure to the same underlying stock* ▪ Often run on an "absolute return" basis (i.e., with the intention of a strong return relative to cash) using short-selling and varying degrees of gearing (leverage). ▪ Strategies are dependant on manager skill rather than market exposure. ▪ Choice of direct investment or Fund of funds approach.	▪ Offers potentially higher returns than other asset classes. ▪ Many top-flight managers have moved into hedge fund management. ▪ Low correlation with other asset classes providing diversification benefits. ▪ "Absolute return" products likely to perform better than equities in a falling equity market.	▪ Significant inflow of assets over past years. ▪ Reliance on manager skill. ▪ Depending on investment vehicle used may be illiquid. ▪ Many funds are closed. ▪ Lack of transparency and regulation and associated monitoring difficulties. ▪ Fees are typically high. Fund of funds structure creates another level of fees.