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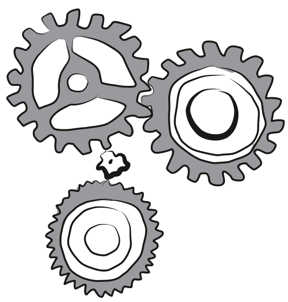
Global Benefits Vision

Knowledge & Wisdom for Global Employee Benefits Professionals



GLOBAL BENEFITS VISION

Knowledge & Wisdom for Global Employee Benefits Professionals

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Global Benefits Vision
Editor & Founder

Eric founded Global Benefits Vision and is its editor and CEO. Earlier, he had founded Aquamarine Consulting, a boutique management consultancy providing strategic advice on their global employee benefit activities to insurance companies, paritarian institutions, investment banks, mid-sized brokers and others.

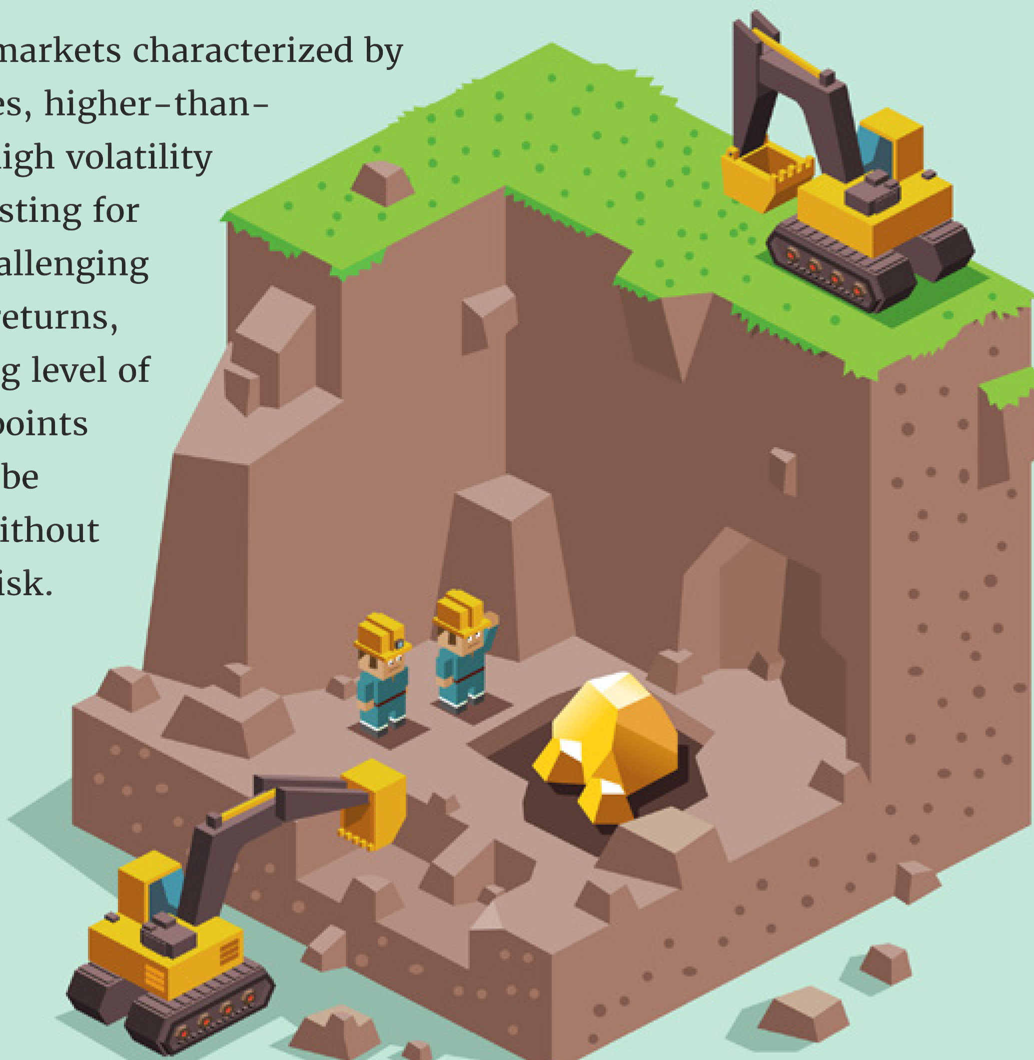
He was previously CFO for several AXA divisions and the first CEO of the MAXIS pooling network, an AXA-MetLife joint venture. Mr Müller-Borle has an MSc from HEC Paris business school and is a CFA charterholder.

→ PAGE 08 : *Are Alternative Investments Suitable Assets for Long-Term Insurance Liabilities and Pension Funds?*

Are Alternative Investments Suitable Assets for Long-Term Insurance Liabilities and Pension Funds?

In a low-interest rate world, alternative investments may provide some relief – and unexpected benefits too.

In today's financial markets characterized by very low interest rates, higher-than-expected risks, and high volatility in equity prices, investing for the long term is a challenging proposition. Decent returns, even at the unexciting level of one two percentage points above inflation, may be difficult to achieve without bearing substantial risk.



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Eric Muller-Borle

At the same time, the volume of long-term liabilities connected with pensions, long-term care claims, or chronic diseases, to name but a few examples, is continuously growing. Pension premiums are still higher than pension payouts, despite predictions to the contrary. And high medical inflation ensures that the cost of treating long-term- care cases or chronic conditions will continue to outpace the returns on managed funds, resulting in the need for renewed injections of investable cash to maintain the balance of asset and liabilities mandated by regulations and common sense.

However, some investment categories have done substantially better than risk-free cash, low-risk government bonds, or listed equities. Carrying unfamiliar if not downright frightening monikers such as hedge funds, private equity, project finance, and real estate, and going under the common name of "alternative investments," they require discipline and good communications. Still, they may result not only in superior returns, but also in a better match between the assets and activities being invested in and the needs and wants of insurance beneficiaries, especially current and future pensioners.

As returns from traditional investments have plunged, alternative assets and innovative strategies ought to be considered.

By definition, alternative assets include all investable assets other than cash, most equities, and bonds. The most common alternative assets today are real estate, hedge funds, and capital goods.

Some Alternative Asset Classes

- Hedge funds
- Real estate
- Commodities, including precious metals
- Financial derivatives
- Private equity
- Venture capital
- Capital goods such as ships, commercial aircraft, heavy machinery, car fleets, etc.
- Art, wine, antiques, stamps, coins
- Film production

Alternative assets provide investment opportunities that exhibit low correlation with traditional asset classes, and therefore provide diversification benefits to investment portfolios. As a result, they generate improvements in the risk-return profile of diversified portfolios. However, they are less liquid than traditional asset classes, even if liquid alternative investment vehicles have become more common since the great financial crisis of 2007-2008.

Alternative investments are not the only way to enhance investment income. Innovative investment strategies of traditional assets also have been developed.

VaR
ValueAtRisk

ETF
Exchange Traded Fund

AIMA
Alternative Investment Management Association

CAIA
Chartered Alternative Investment Analyst association

Some innovations pertain to the asset allocation process, for example so-called "Smart Beta" approaches, which combine a passive, index-tracking investment philosophy with optimization techniques; or Risk Budgeting, in which your maximum exposure to "risk," often quantified by the ValueAtRisk (**VaR**) measure, is allocated in the most efficient manner possible.

Other innovations result in investment products matched to investors' needs, including target date funds (especially valuable when a pension plan pays a lump-sum upon retirement) and life-cycle programs, liquid alternative vehicles, and active **ETFs** (exchange traded funds).

Finally, more innovation has been forthcoming in the area of non-liquid instruments, such as mini bonds and private debt.

With the 2007-2008 financial crisis as a driver, most of these developments are recent ones, and many open issues remain. Among these, the weight to be given to alternative assets in a diversified portfolio for a retirement plan or other long-term—read 30- to 40-year—investment is not yet a matter of consensus. Some even argue that alternative strategies might be an optimal solution for the management of such a portfolio, fully replacing traditional investments.

In this context, the track record of alternative assets and innovative strategies for fixed income portfolios appears to be a mixed one, but innovations such as target-date funds may improve their risk-return profile in the current environment. Many countries still prohibit or severely limit investments of pension assets in alternative assets or innovative but non-liquid instruments.

The main difficulty appears to be a discrepancy between long-term assets and liabilities calling for long-term actions and the long view in reporting, on the one hand, and the short-termism that pervades politics and decision-making, both corporate and public, on the other hand. Those alternative investments most suitable for long-term investments are often illiquid in the short term, and their day-to-day pricing may be highly volatile. This does not matter as long as these assets are held for a long period of time. Trouble starts when they must be disposed of much earlier than planned and committed to, even if this disposal is not actually realized but only contemplated or simulated, as is the case with "mark-to-market" accounting principles. Existing US GAAP and IFRS accounting rules are probably well-suited to short-term, i.e. quarterly, activities; they do not appear to be adapted to long-term endeavors and may actually signal major issues where there is none and cause a panic, resulting in a sort of self-fulfilling prophecy.

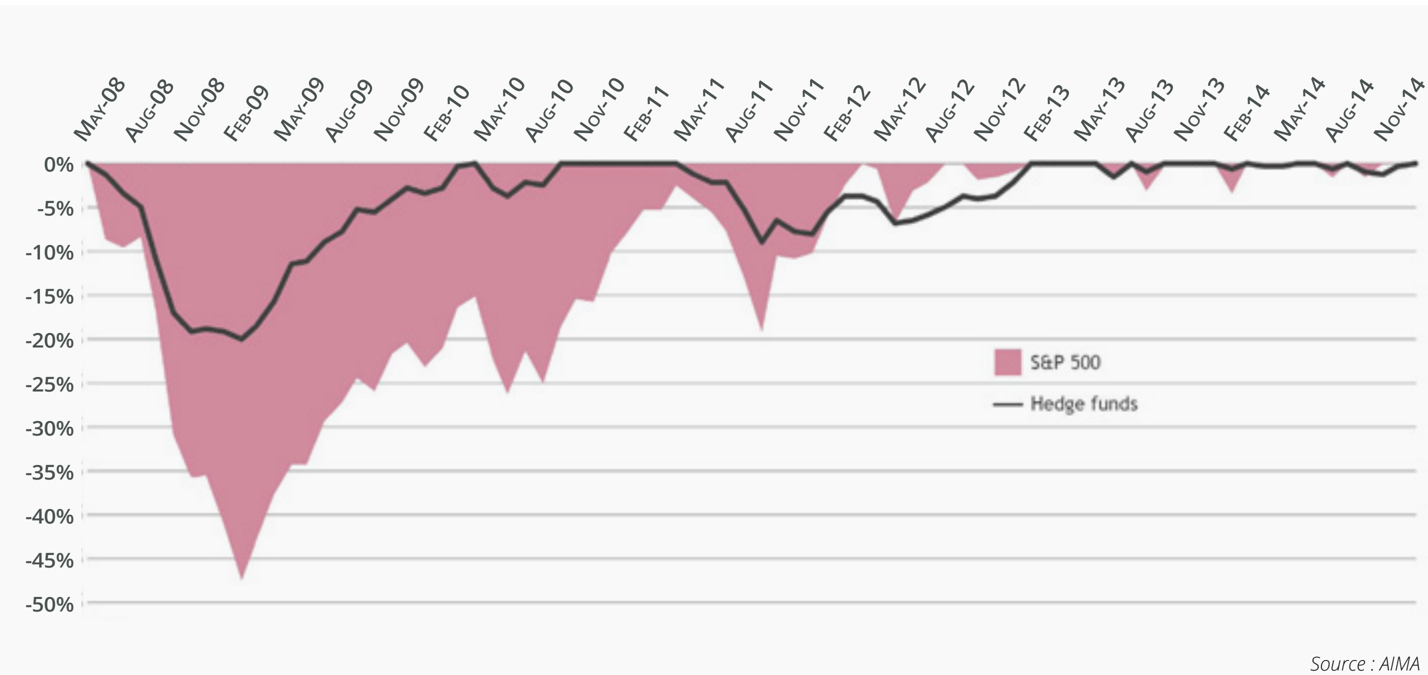
Going back to basics, some alternative assets may be good candidates for long-term investments due to the very nature of their underlying cash- and return-generating mechanisms.

AIMA AND CAIA'S TRUSTEE EDUCATION INITIATIVE

Beginning in January 2015, **AIMA** and **CAIA** launched a joint initiative to help trustees and other fiduciaries better understand and manage the risks and opportunities associated with hedge fund investing.

In their early days, hedge funds, through a lack of oversight and a dearth of transparency, and with the help of Hollywood's passion for a good story, made a name for themselves as bastions of greed, excess, and unchecked power. Today, hedge funds are among the most closely regulated investment vehicles. The European

Exhibit 1. Drawdowns of hedge funds vs. S&P 500, May 2008 — December 2014



Source : AIMA

Union's 2010 **AIFMD** (Alternative Investment Fund Manager Directive) and several U.S. laws, including Regulation D of the Securities Act and the Dodd-Frank Act, restrict both what hedge funds can do and to whom they can be sold.

A first paper from **AIMA** and **CAIA**, "The Way Ahead: Helping Trustees Navigate the Hedge Fund Sector," provides practical guidance about how existing investors have managed issues and challenges associated with their hedge fund investments, and details the advantages of allocating to hedge funds.

Investors allocate to hedge funds for several reasons, mainly for the benefit of low correlation with other asset classes and for downside protection.

Hedge funds tend to exhibit a low correlation to other more traditional investments in the portfolio. Therefore, inserting hedge funds in a diversified portfolio can significantly improve its overall risk-return profile.

In addition to better diversification, hedge funds are designed to provide greater protection against the large drawdowns or peak-to-trough losses sometimes experienced by main asset classes. As a result, hedge funds outperformed the main standalone asset classes over the 10 years to 2014 with a cumulative return of 74%, with a maximum drawdown of 21.4%.

This then begs the question of whether hedge funds should be used as diversifiers, or whether they could be substitutes for traditional assets. In fact, the great variety of hedge funds includes ones suitable for diversification purposes, such as Global Macro funds, Managed Futures funds, and Equity market-neutral funds; as well as substitutes, including Long/short equity funds, Long/short credit funds, Event driven funds, Fixed income arbitrage funds, Convertible arbitrage funds, Emerging markets funds, and more.

For example, adding a Global Macro fund to an existing portfolio diversifies its exposure by adding assets from foreign countries and indirectly some exposure to foreign exchange risk, all of which may well be inversely correlated with the main portfolio, thereby reducing the aggregate risk of the total portfolio.

AIFMD
Alternative Investment Fund Manager Directive

Another example would be replacing at least a part of the pre-existing domestic equity portfolio with a Long/Short domestic equity fund. In such a fund, returns are enhanced by short investments (negative positions) on stocks deemed to have poor prospects and expected to lose value, in addition to normal investments in stocks with good projections. The stock-picking process is all about analyzing a great number of stocks and separating the wheat from the chaff. Traditional long investing consists of buying and holding "wheat" stocks; long/short investing takes advantage of all the hard work put in analyzing all stocks by adding the short-selling of the "chaff."

KEY TAKEAWAYS

Different investor mandates should lead to different overall asset allocations in a given investment portfolio, resulting in a different level of risk-adjusted returns, and a different role for hedge funds in the portfolio.

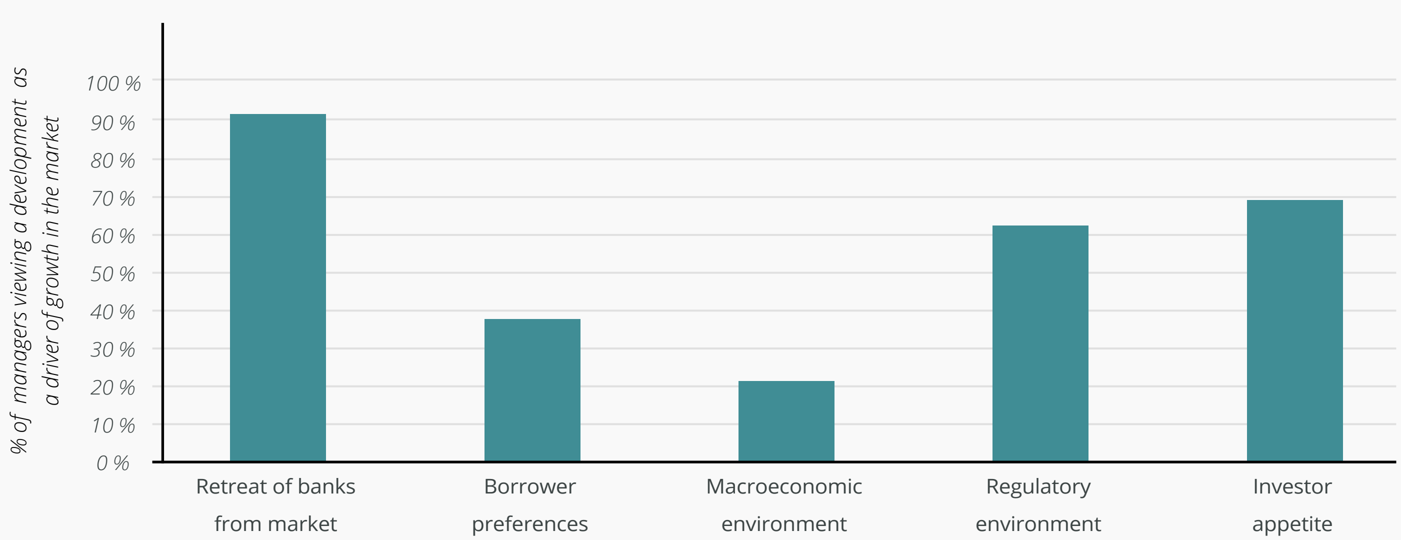
The breadth of the hedge fund universe allows investors to evaluate and classify hedge funds according to a series of risk factors and use different strategies in portfolio construction. In a quest for higher returns without incurring more aggregate risk, institutional investors are moving away from the traditional portfolio of investing in bonds and equities and are increasingly using hedge funds as volatility dampeners. Furthermore, investors who believe that public markets will exhibit increasing uncertainty and volatility should consider increasing their allocations to unconstrained strategies.

ALTERNATIVE INVESTMENTS INCLUDE MORE INVESTMENT POSSIBILITIES

Another by-product of the 2007-2008 financial crisis, and more specifically of the reluctance of banks to do their job of lending money to firms and to private persons, so-called private debt is a relatively new but very interesting investment vehicle, especially in the context of long-term investments.

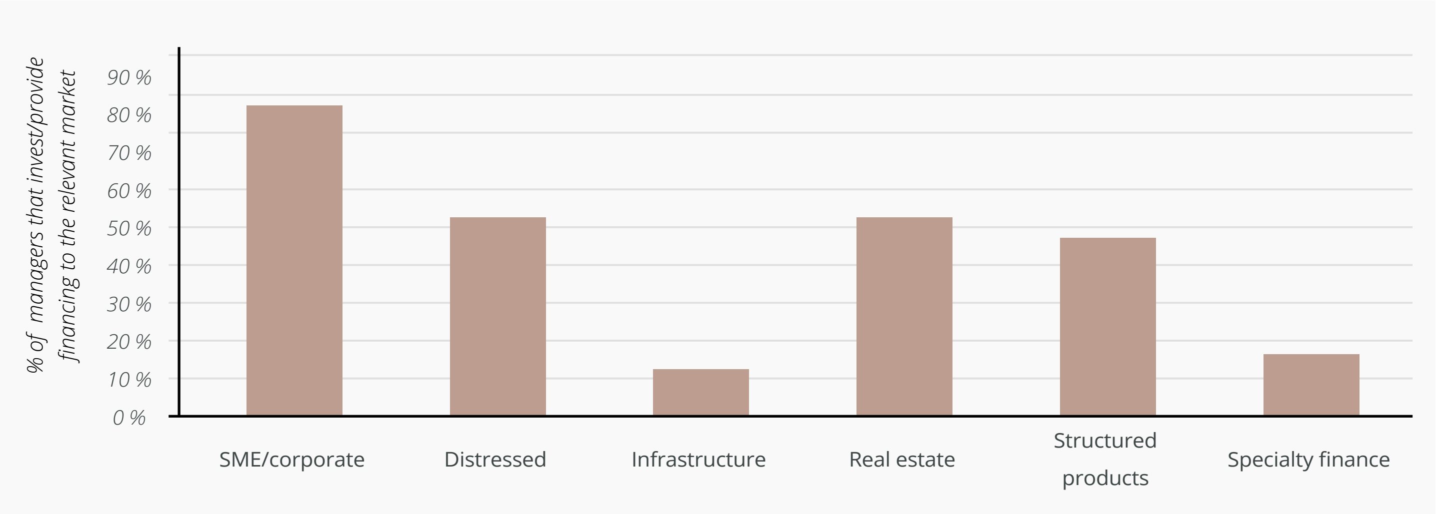
The retreat of banks from the lending market, combined with investor appetite and a favorable regulatory environment, is resulting in a very active private debt market.

EXHIBIT 2. DRIVERS OF GROWTH IN PRIVATE DEBT



Source : AIMA

EXHIBIT 3. PRIVATE DEBT MARKETS THAT MANAGERS PARTICIPATE IN



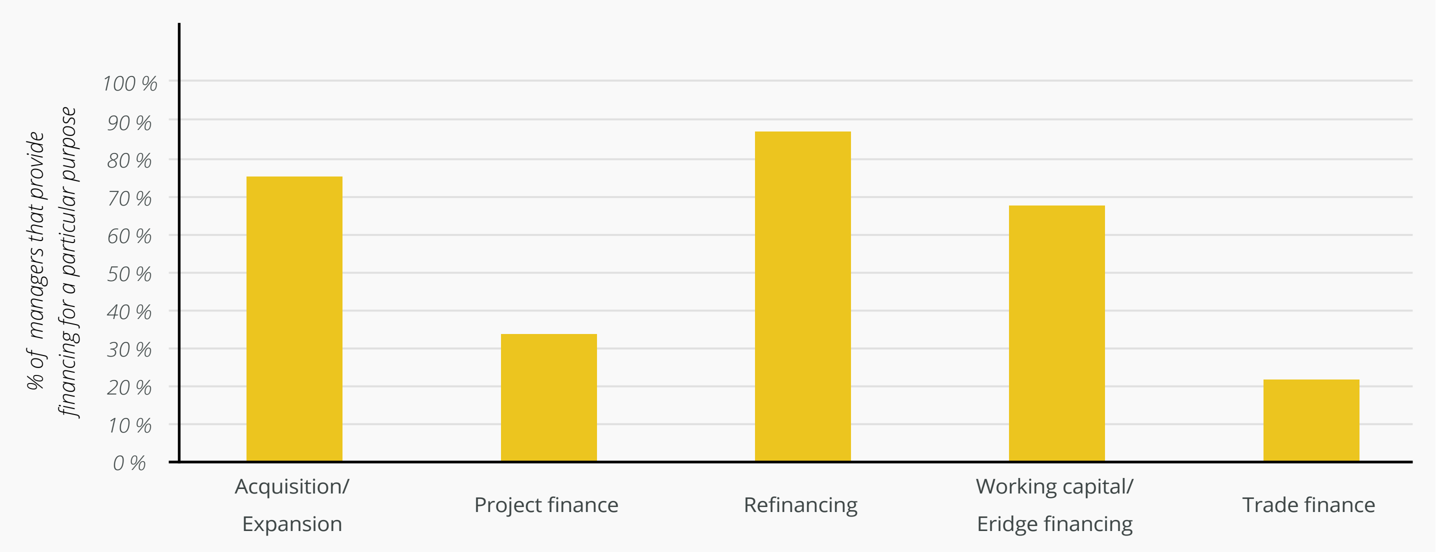
Source : AIMA

Private debt is broadly defined as investments in loans; private debt securities, including forms of private debt securitizations; other instruments with debt; or hybrid debt characteristics used for the financing of companies or projects by asset managers. In all these cases, money is ultimately made available to a corporate borrower as a loan.

AIMA considers distressed debt investments, mezzanine financing, real estate, and infrastructure financing, as well as other forms of opportunistic and short-term lending, such as bridge financing, to all fall within the definition of private credit. Asset management firms participating in the **AIMA** private debt survey account for assets under management of approximately \$530bn – \$85bn, 16% of which is allocated to private debt strategies.

Interestingly for pension plan trustees and participants, private debt managers play an increasingly crucial role in financing the real economy. Almost all of them make loans to SMEs and corporates, and approximately one-half lend to distressed firms with no access at all to funds from banks. Investments in real estate and providing leverage in LBO operations also account for some of the private lending activity.

EXHIBIT 4. PURPOSES OF FINANCING

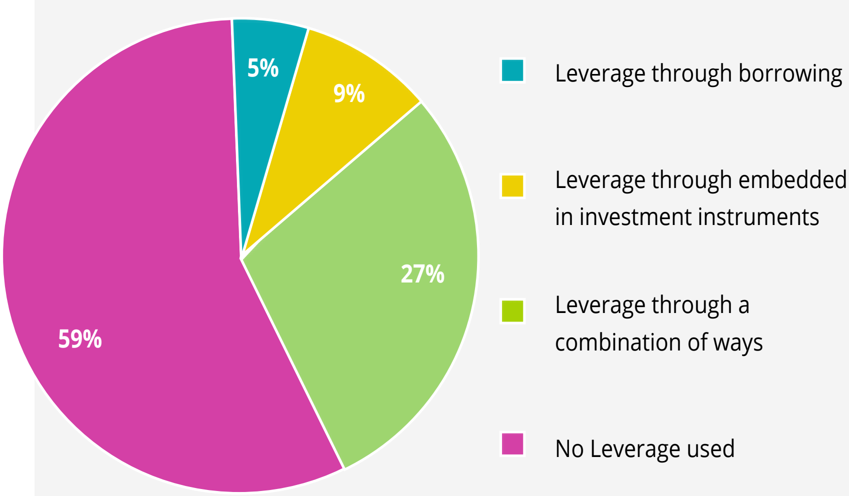


Source : AIMA

Most of the money is used for refinancing purposes, which includes situations of financial distress as well as LBOs and other businesses in good shape whose banks will not renew their existing loans. The second most frequent use is for financing internal or external growth through the acquisition of capital goods or of other companies; the third use is the financing of day-to-day operations, a common need of undercapitalized firms experiencing high growth, a very common feature of SMEs. Most of these needs used to be met by banks, whose new reluctance to lend has created a market for private debt.

Financial resources, or in other words, private debt funds' liabilities, comprise mostly capital as opposed to debt. Private debt managers use minimal leverage, and senior secured investment is preferred. Therefore, private debt funds transform capital or equity into loans, i.e., fixed-income instruments. Of course, private debt funds exhibit the financial behavior of a fixed-income instrument, but their owners are shareholders, not bondholders or lenders, and do not benefit from the recourses and securities that lenders and other fixed-income investors usually enjoy.

Exhibit 5. Private debt funds use of leverage



Source : AIMA

CASE STUDY PRIVATE DEBT: OMNI PARTNERS

OMNI's founder Steve Clark identified an opportunity by recognizing a secular shift, namely that the ability of banks post-crisis to serve as transmission mechanism for money to flow into the real economy has suffered. Key factors are the impact of regulatory changes on encumbered banks, the continued evolution of technology, and the emergence of new models for lending.

Once it was clear that these factors were structural in nature and not likely to go away soon, Clark's pivot toward the private credit sector became obvious. After more than 25 years as an equity trader, in 2009 he decided to build an alternative lender from the ground up. Previously, he had founded OMNI in 2004, with a focus on hedge fund strategies trading liquid investments. But the opportunity presented after the global financial crisis was staggering – OMNI had capital to allocate and no legacy issues with which to contend.

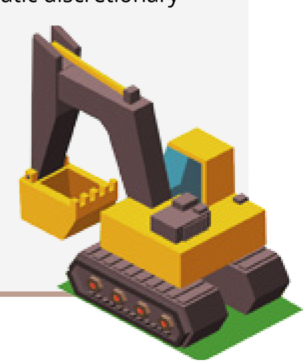
OMNI Partners

London-based Asset Manager

Founded in 2004

Manages nearly $860 million (as of October 2015) across three strategies open to external capital

- → Omni Event – equity event-driven focus
- → Omni Macro – thematic discretionary macro strategy
- → Omni Secured Lending – short-term U.K. property lending



Omni Secured Lending Fund II

Background

- Market opportunity identified in wake of Great Financial Crisis
- Inverted yield curve in U.K. property lending: shortest duration attracts highest yield
- Set up short-term lending origination platform – Amicus
- Origination in excess of £30 million per month

Portfolio Size

- Overall exposure $422 million
- Diversified funding sources:
  - Related-party capital: $82 million
  - Omni Secured Lending Strategy: $195 million
  - Securitization: $145 million

Lending Profile

- Loan Duration: 6 to 18 months
- Security backing: hard assets – U.K. property
- Borrowers: sophisticated property investors
- Loan-to-value: max 70%
- Monthly pricing: 0.9% to 2%
- Granular portfolio: average loan size £700k

Market Characteristics

- Premium pricing for speed and certainty of execution – average annual yield 15.2%
- Loans priced for risk – experienced specialty lending expertise required
- Strong security coverage – full recourse market and creditor-friendly legal system
- Compelling historic credit performance – principal loss suffered on 10 loans to date (<0.2% of capital loaned)

Risk Management

- Strong underwriting provides initial protection
- Primary focus on asset
- Secondary considerations: exit viability and borrower creditworthiness
- Proactive servicing and collections support underpins credit decisions
- Exit strategies actively monitored
- Recoverability proactively assessed if enforcement becomes necessary
- Hands-on experience in working loans out

Funding disappeared on a wide scale from certain markets, so lenders with capital could operate from a position of strength. Initially, OMNI focused on short-term property lending. In that segment of the market, borrowers in the U.K. relied increasingly on alternative lenders as underwriting decisions became increasingly centralized within banks, leading to inflexibility and slow processing speed; as the uncertainty of finance being available at all presented issues for sophisticated property investors; and as borrowers were willing to pay a premium for speed and certainty of funding.

On the other side of the balance sheet, potential institutional partners exhibited a strong demand for yield in the current environment as they were struggling to meet required returns without taking undue risk. This resulted several years later in the mainstream adoption of private credit strategies by institutional investors, with private debt and alternative lending strategies gaining traction with allocators and being a part of the alternatives allocation for most investors today. However, investor education remains a challenge and it is understood that the private credit industry will reach scale when allocations transition into the huge fixed-income bucket.

OMNI offers both a fund, Omni Secured Lending, and co-investment opportunities and bespoke mandates, such as longer dated lending and larger tickets within real estate and other areas such as equipment finance, factoring/ invoice discounting, etc.

PRIVATE EQUITY: AN OOPPORTUNITY FOR PENSION FUNDS

Today, a broad and diversified range of managers and funds offers private equity opportunities to investors.

Venture capital is usually considered to be a different category than private equity, even though both invest in the very same companies, though not at the same stage in their development. Venture capital invests at an early stage in the life of a business and private equity takes over when some degree of maturity is reached. Venture capital firms do expect that most of their investments will fail and that a small number will bring huge returns; in contrast, private equity funds do not plan for more than a very small number

Segmentation of Private Equity Funds

Life stage of target:

- start-up,
- development,
- buyout,
- restructuring

Geography:

- local,
- domestic,
- regional,
- international

Investment size:

- small (<30m EUR),
- medium (30m-50m EUR),
- large (>150m)

Investment policy:

- generic,
- sectorial,
- geographic,
- mixed,
- ...

Control:

- minority stake,
- controlling stake,
- both

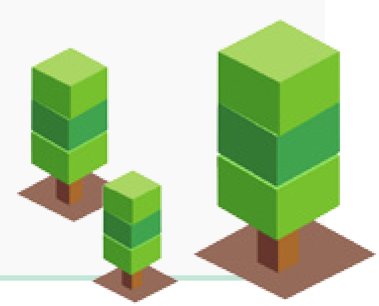
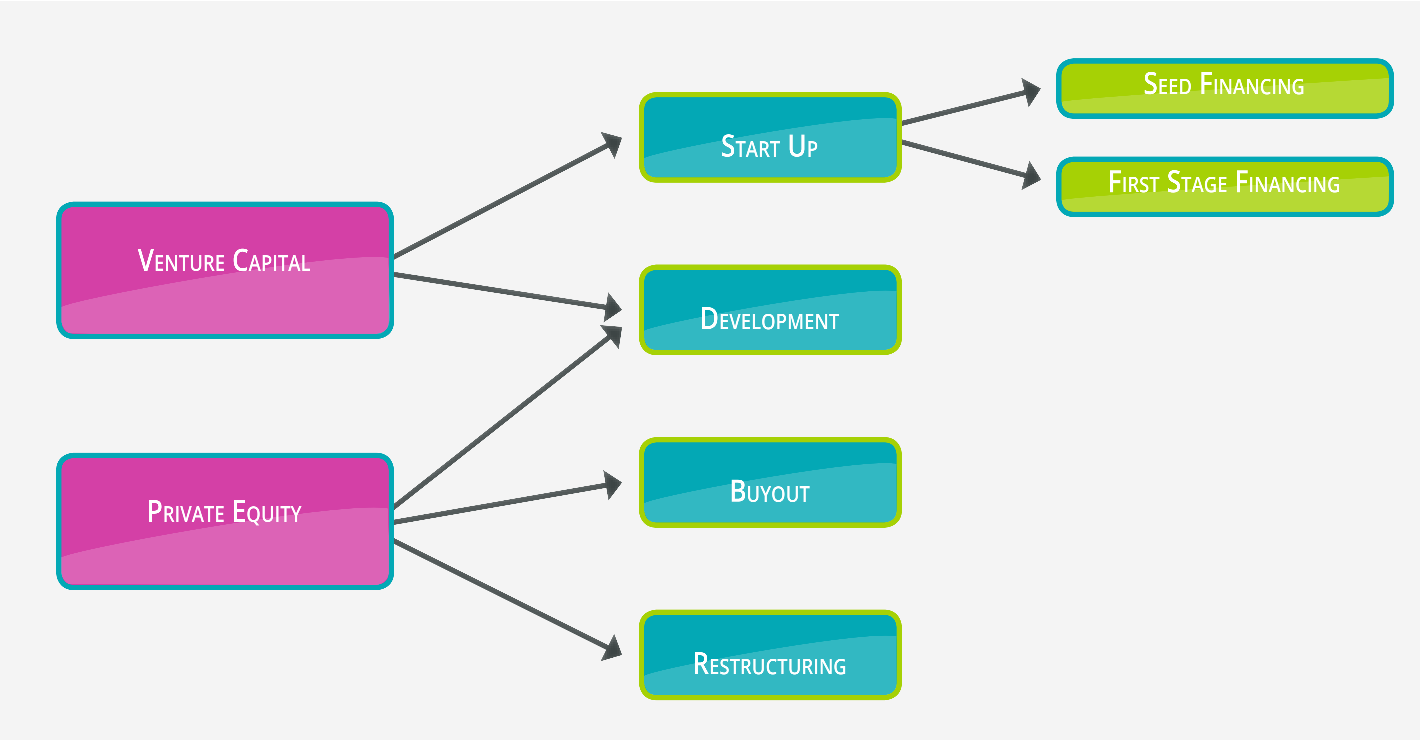


Exhibit 6. Comparison of Venture Capital and Private Equity



Source : AIMA

of their investments to founder. Therefore, investing in venture capital funds may not be a choice with which institutional investors such as pension plans are comfortable. Despite a lack of familiarity, private equity investments may be worth considering.

The reason most often quoted to invest in Private Equity is its superior returns. Private equity investments enjoyed an 11.8% average return over the past 10 years[1], a far better performance than listed instruments. And these superior returns were achieved with lower volatility than other alternative instruments with similar returns[2].

Perhaps most importantly, private equity allows investors to access unlisted securities markets and therefore it allows them to invest in SMEs. Such investments are not only desirable from a purely financial, risk-return standpoint, but also for more political reasons, such as supporting a local economic fabric consisting primarily of smaller companies with no access to financial markets.

Local pension funds in particular may want to invest locally and sectorial pension funds may want to invest primarily in their own sector, where most investment opportunities may well be in unlisted SMEs. However, whether investing one's retirement savings in one's employment sector, making one's current and future income dependent on the continued good state of a single economic area, is a good idea from the point of view of diversification is an interesting issue that this publication will save for another in-depth article.

Going back to private equity investments in general, other advantages include partial decorrelation to listed securities and hence diversification benefits; portfolio stability, as these securities are not marked to market, that is, revalued daily, but often on a quarterly or a semi-annual basis; private equity investments may be contributing more directly to the "real economy" than are purely financial products; and there may be tax incentives in certain jurisdictions pertaining to the duration of the investment or to eligible investees, for example.

1 *Source: Guide to the Markets, JP Morgan Asset Management, September 2015*

2 *Source: Guide to the Markets, JP Morgan Asset Management, September 2015*

Despite these compelling advantages, some question marks do remain in respect of private equity investments.

Private equity funds have an unwarranted reputation for opacity, especially now that the rules in the **AIMFD** in the E.U., and in similar legislation in the United States, have made mandatory disclosures very comprehensive.

Hedge funds and private equity have a somewhat-deserved bad reputation, due to scattered but well-publicized predatory behavior and excessive risk-taking, especially in the form of unsustainable leverage, by some fund managers in the early days of the industry. This bad reputation was compounded when the same managers tried to save their funds from the financial mess they themselves had created by stepping into the management of their acquisitions and requiring (if not executing) ruthless restructurings. This resulted in short-term improvement of financial indicators and in the ultimate commercial demise of their investments, often soon after they had divested. Such risks can be averted by carefully selecting private equity funds and steering clear of highly leveraged structures and of management firms that have a blotted track record in managing their portfolios.

Certainly the asymmetry of information between private equity fund managers and their investors is an issue that can be mitigated only partially. Limited Partners can request and receive a great deal of information, but they will never match the time and effort that fund managers put into knowing their acquisitions inside and out.

Aside from these three issues that can be kept under control, other questions remain. Private equity investments are illiquid, meaning they cannot be traded at will. Selling shares in a private equity fund may not be possible or even allowed, depending on its articles of association. Furthermore, the fund itself may not be in a position to sell its holdings quickly, as the typical duration to sell a SME is six to nine months when a suitable buyer exists at all, and that may not always be the case. Therefore, private equity investments are definitely of a buy-and-hold nature, almost the exact opposite of what a day-trader likes to play with, but well-suited as a counterpart to liabilities that do not require high levels of asset rotation, such as pensions.

With investment horizons of 5-7 years, most private equity funds live for about 10 years from inception to liquidation. This certainly makes them long-term investments, when long-term is defined by bankers as anything over 3 years and by insurers as over 5 years. At the same time, precisely this characteristic makes them very suitable for pension plans, which often have liabilities with durations of 20 years or more.

Unlike bonds, loans, or other fixed-income investments, private equity investments generate cash flows that are uncertain in both their amounts and their timings. The initial investment into a private equity vehicle is usually made in steps as the fund invests in target companies, which happens in seemingly random increments over the course of the first years in the life of the fund. Then, payouts from any dividends and divestitures happen whenever exits are effected, which cannot be planned, and would be counterproductive to plan, precisely in advance.

Finally, the so-called “J curve” effect must be contended with. In the first years of the life of a private equity fund, its value actually decreases below the value of the invested cash. This is due to the management team drawing salaries and other running costs, when at the same time target companies have not yet been acquired and no investment income is generated. Even after target companies are acquired and their performance improves, it takes time before they can be revalued upwards. Typically, three to five years are needed for the valuation of the fund to come back to 100% of the invested money and begin its ascension to great heights. Hence the moniker "J-curve," which starts with a dip followed by a steep rise in the later years.

The "J-curve" is one of several sensitive topics for pension funds. Investing in private equity has a negative impact on the pension fund's short-term returns, which may be an issue, especially if many members are retiring during the initial investment period. Despite what common sense would seem to dictate in their long-term environment, boards of pension funds, who must approve the investment, often only see the immediate negative impact.

By the same token, the cost structure of a private equity fund is substantially higher than that of managing listed securities, due to the greater quantity of work required in the investment process. These costs may be more than offset by higher portfolio returns, but they do increase the aggregate cost ratio of the pension fund, which is one of the key performance indicators in a pension fund and which boards may be reluctant to degrade, even if only in the short term and for good reasons.

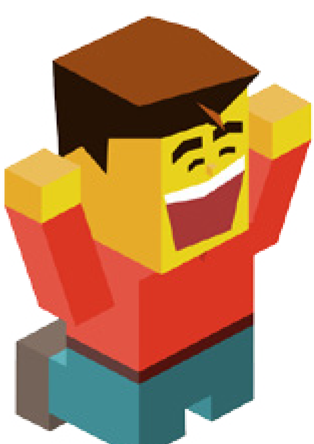
Finally, selecting and monitoring private equity managers and funds is difficult because of the diversity of offers in the market, which are not easy to compare. The necessary due diligence is complex, requiring time, expense, and expertise,

which all may be in short supply. And the ongoing monitoring of investments also requires skills and a mindset adapted to the peculiarities of these investments.

But for those willing to take the plunge, private equity investments have the potential to offer a good alignment with the characteristics of long-term liabilities and sometimes with qualitative requirements of plan participants, while enhancing the aggregate risk-return profile of the overall portfolio.

CASE STUDY: ASSIETTA PRIVATE EQUITY AND SOLIDARIETÀ VENETO PENSION FUND

Assietta Private Equity is a small independent private equity fund management company dedicated to Italian S(M)Es. Its investment focus is on Italian SMEs, especially in Northern Italy, that are sector leaders, with good growth perspective, excellent operational and financial performance, an international strategy, and in a market with expansion and/or buyout opportunities. Target companies have turnovers between €10m and €30m, make a moderate use of leverage, and are prepared to grant Assietta controlling interest in their firm.



Solidarietà Veneto is a regional paritarian pension fund dedicated to people employed in the Veneto region, that is Venice and the mainland north of it. Founded in 1990, Solidarietà Veneto has 48,000 members and EUR 1bn in assets. It is the first Italian paritarian pension fund that invests in private equity.

Before Solidarietà Veneto even began its journey toward investing in private equity, it had to set the stage by acquiring relevant competencies and hiring dedicated staff; determine and implement a suitable fund selection process; retain advisers that would inform its forthcoming decisions; get specific internal approvals, particularly from its Board of Directors; and from an asset allocation perspective, get an approval in principle to invest up to €30m in private equity, a decision that belonged to the Investment Committee and the main Board. The paritarian nature of Solidarietà Veneto meant it was necessary to educate and convince both employers and employee representatives, which goes some way toward explaining why it took 18 months from the initial presentation by Assietta to the closing of the €7m deal. The detailed due diligence conducted by Solidarietà Veneto with the help of outside advisors resulted in Assietta modifying its standard limited partners’ agreement to better suit the needs and wants of its investor.

CONCLUSION

A growing number of pension fund trustees are requesting that investments be made in a socially responsible way, which may be defined as investing locally, outside of big business or certain industries, etc. Insurance companies with long-term liabilities arising from defined-benefit pensions, and long-term care and chronic diseases claims, also are considering and implementing socially responsible investments, at least for part of their portfolios.

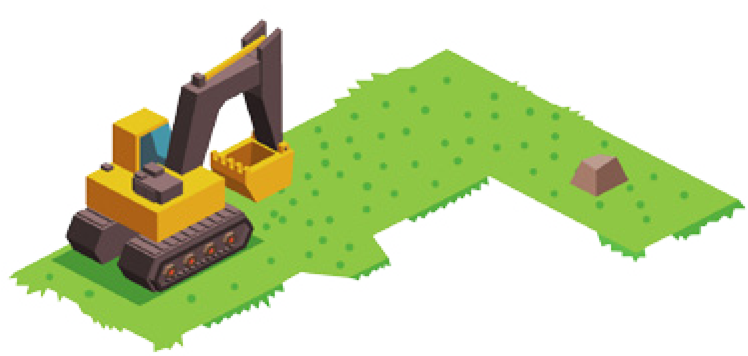
Traditional investments in bonds, equities, and cash, especially when managed passively (that is, with a market index as their benchmark) often cannot meet these demands, as they must invest in firms with large capitalizations, diversified activities, and a global footprint, and often have a hard time avoiding the taboos of socially responsible investing.

Alternative investments in private equity and private credit have the potential to provide capital and loan for SMEs, which by virtue of their small size tend to be more focused, in terms of business and from a geographical standpoint. Through SMEs, targeted investments in specific regions and industries become possible. Alternative investment managers handle the intricacies of investment selection, acquisition, and divestiture.

Apart from private equity and private credit, other alternative investments such as hedge funds, real estate, and project finance may provide both diversification and higher returns, which is particularly important in an era of very low risk-free returns.

One potential limitation may be a dearth of suitable investment opportunities among SMEs. Already today, many private equity funds have a difficult time investing funds entrusted to them by their own investors. Already, some argue that a glut of private equity money has resulted in excessive valuations, if not a bubble. If pension funds and insurers bring even more cash into play, we may see either an explosion in valuations or money flowing into hitherto unfunded but worthwhile projects.

The long-term nature of pensions and the increasingly socially responsible mindset of trustees and beneficiaries make some alternative investments an excellent match for at least part of pension liabilities. Pension specialists should take heed and begin a learning and education process. ∞



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