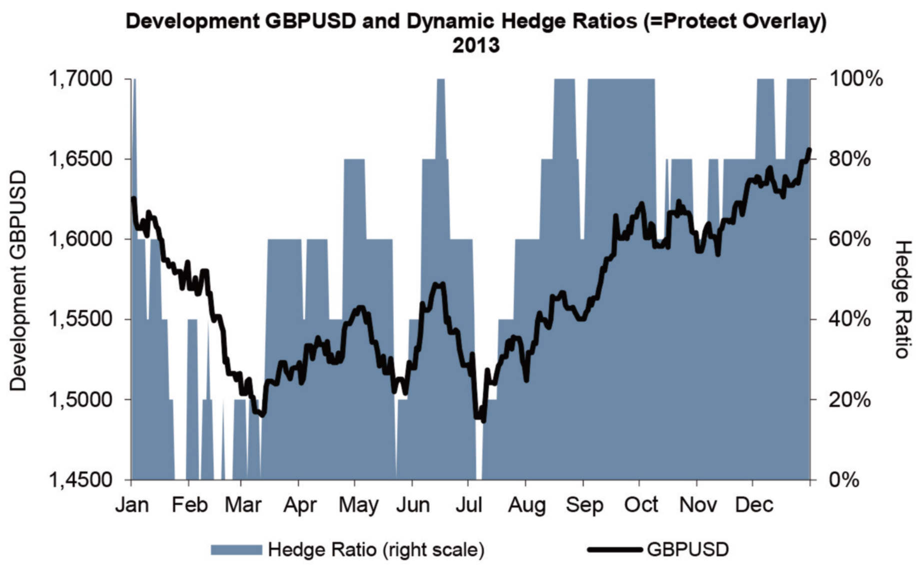
Managing risk to improve returns

The importance of return generating classes such as equities is proving beneficial to local authorities

The LGPS and its constituent Local Authority Administered Pensions Funds have provided local government employees with high quality and secure pensions for many years. They have been able to do so by remaining open to new investment thinking and embracing new investment opportunities whilst carefully managing the associated risk that comes with the search for higher returns. In doing so, one of the first significant steps that LGPS funds took some years ago was to reduce the natural "home bias" of investing in Sterling denominated assets and looking to foreign investment markets to both increase and diversify the investment returns available to them.

More recently, as both legislative changes and financial crises have taken their toll on funds, turning surpluses to deficits, the need to produce consistent investment returns has become ever more pressing. Unfortunately, officers and trustees are faced with a classic dilemma – the traditional "low risk" assets of cash and government bonds are offering historically low, in some cases, negative returns, whilst the appetite for taking on more risk in order to generate more returns is constrained by the already large deficits that many funds face. Thus, the management of risk in return generating asset classes, such as equities, has become of paramount importance.



With its German roots, going back to its foundation in 1590, its private ownership and personally liable partners, Berenberg has always paid particular attention to managing risk. Management of risk is at the heart of what Berenberg's asset management division can offer local authority clients. By actively managing the risk of owning return generating assets, funds can reduce volatility of returns, i.e. reduce the risk of owning the asset, and therewith choose to own more within their overall risk budget.

Of particular interest to LGPS funds has been management of the currency risk that they bear through owning assets, predominately equities, quoted in currencies other than Sterling. The currency risk is an inescapable and unrewarded risk that comes with the benefit of diversifying outside the home market. It can be ignored, opening the possibility that any returns arising from a rise in share prices is negated, or even reversed, by a fall in the underlying currency. It can be removed by way of passive currency hedging – selling the foreign currency in to Sterling as soon as the purchase of the asset is made. This has the disadvantage of requiring large liquidity to be available to feed the hedge positions if the hedge goes against you, and the underlying currency appreciates against sterling. In practise many funds have chosen to adopt a middle way, and hedge 50% of their currency exposure on a static basis. However, we believe that by adopting a flexible approach, and employing a trend following model that automatically hedges when currencies depreciate, but removes the hedge when they appreciate, funds can not only protect themselves against depreciation but also benefit from currency appreciation, and all at a much reduced demand on the liquidity of the fund. Berenberg are already working with a number of UK funds, including members of the LGPS, in managing trend following quantitative based dynamic hedging solutions to enhance the returns that can be generated for Sterling based clients owning foreign assets.

Whilst LGPS funds have recognised the desirability of managing their currency risk, and continue to evolve their approach to doing so as they move from static to dynamic hedging, the risk of owning equities more generally has not been so fully addressed.

Historically, UK pension funds, including local authority funds, have had a high exposure to equities – typically more than 50% of their assets. Whilst this has fallen over recent years, equities remain a very significant component of the return generating engine for most funds. This is particularly so at a time when alternatives, such as bonds, are sitting at historically low yields, along with the other "lower risk" assets. If deficits are to be reduced, investment returns must be generated, implying the acceptance of higher risk. In Europe, and especially in Germany, equities have always been perceived as risky assets, leading to a much lower allocation to them, relative to bonds, than in the UK. To reduce the risk of owning equities further, most German funds seek to protect themselves from equity market falls by putting in place a hedging strategy against underlying equity indices. This has not been common practice in the UK, but, with funds already in deficit and requiring returns, but with very limited capacity to stomach even short-term falls in capital values, it is becoming of more interest. Berenberg has long experience with working with German pension funds in creating equity market hedges that protect funds from general market falls whilst allowing participation in market rises. These are totally independent of the underlying stock selection process undertaken by third party fund managers employed by the fund, but address the risk of exposure to equity markets in general. As a result, funds can choose to reduce the risk of an allocation of equities or increase the allocation for the same level of risk. By avoiding the big market falls through efficient hedging, returns form equity investment are also substantially increased.

The same techniques are also employed to hedge duration risk in bond portfolios – of particular significance at a time of historically low bonds yields and interest rates, although of course a rise in bonds yields would have the impact of reducing actuarial deficits. However, a dynamic hedge on a fixed income portfolio would also reduce the financial deficit of a fall in capital values in bond markets as interest rates rise.

It is our privilege at Berenberg to work closely with members of the LGPS. We have the solutions and the expertise to meet the unique requirements of local authority clients, in helping them to substantially improve the returns that they can generate by managing the risks that they are forced to take to do so.

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