

# Developing Investment Strategies

**Presented by**

**Hazel McNeilage**

Managing Director  
Asset Management EMEA

# Overview of the session

- Building blocks: traditional and alternative asset classes
- Diversification: opportunities and pitfalls
- Developing investment strategy for DB plans
- Implementing investment strategy:
  - ◆ Active and passive approaches
  - ◆ Defining benchmarks

# Risk and Return

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	YTD	10 YEAR CAGR
Higher Returns	EM Equities 34.5	Global RE 43.7	Natural Res. 53.0	Gold 5.5	EM Equities 79.0	Gold 29.7	TIPS 13.6	Global RE 29.8	US Equities 32.6	Global RE 14.7	Municipals 1.0	Gold 10.0
	Natural Res. 27.5	Infrastructure 39.5	EM Equities 39.8	Inv. Grade 5.2	High Yield 58.8	Global RE 20.0	Municipals 10.7	EM Equities 18.6	Dev. ex-US 21.6	US Equities 13.4	Inv. Grade 0.4	High Yield 7.4
	Gold 18.4	Natural Res. 33.6	Gold 31.3	Global Fixed 4.8	Natural Res. 53.6	EM Equities 19.2	Gold 10.2	Dev. ex-US 17.0	Infrastructure 15.0	Infrastructure 13.0	High Yield 0.1	US Equities 7.3
	Infrastructure 15.0	EM Equities 32.6	Infrastructure 23.2	Cash 1.8	Global RE 41.3	Natural Res. 18.6	Inv. Grade 7.8	EM Fixed 16.8	60/40 12.3	Municipals 9.1	Cash 0.0	Infrastructure 6.8
	Dev. ex-US 15.0	Dev. ex-US 26.2	EM Fixed 18.1	TIPS -2.4	Dev. ex-US 34.4	EM Fixed 15.7	Global Fixed 5.6	US Equities 16.1	High Yield 7.4	Inv. Grade 6.0	TIPS -0.2	EM Equities 5.8
	Global RE 10.7	Gold 23.0	Dev. ex-US 12.9	Municipals -2.5	US Equities 27.1	US Equities 15.4	High Yield 5.0	High Yield 15.8	Global RE 2.2	60/40 5.0	Dev. ex-US -1.4	60/40 5.3
	60/40 7.5	US Equities 15.3	TIPS 11.6	EM Fixed -5.2	Infrastructure 25.3	High Yield 14.9	US Equities 2.0	Infrastructure 11.9	Cash 0.0	TIPS 3.6	60/40 -1.7	Global RE 5.3
	EM Fixed 6.3	EM Fixed 15.2	60/40 10.0	High Yield -25.9	Gold 24.0	60/40 10.7	Cash 0.1	60/40 11.4	Natural Res. -0.3	High Yield 2.5	US Equities -2.6	Natural Res. 5.1
	US Equities 5.7	60/40 14.2	Global Fixed 9.5	60/40 -25.9	60/40 23.0	Dev. ex-US 9.4	Infrastructure -0.4	Natural Res. 9.0	Inv. Grade -2.0	Global Fixed 0.6	Global Fixed -2.7	EM Fixed 4.8
	Municipals 3.5	High Yield 10.8	Inv. Grade 7.0	US Equities -37.1	EM Fixed 22.0	Inv. Grade 6.5	60/40 -1.2	TIPS 7.0	EM Equities -2.3	Cash 0.0	Gold -4.4	Municipals 4.5
Lower Returns	Cash 3.0	Global Fixed 6.6	US Equities 6.0	Infrastructure -39.0	Municipals 12.9	TIPS 6.3	EM Fixed -1.8	Gold 7.0	Municipals -2.6	Gold -1.5	Global RE -5.9	Inv. Grade 4.5
	TIPS 2.8	Municipals 4.8	Cash 4.8	Dev. ex-US -43.2	TIPS 11.4	Infrastructure 5.8	Global RE -8.1	Municipals 6.8	Global Fixed -2.6	EM Equities -1.8	Infrastructure -6.9	Dev. ex-US 4.4
	High Yield 2.8	Cash 4.8	Municipals 3.4	Natural Res. -45.3	Global Fixed 6.9	Global Fixed 5.5	Dev. ex-US -11.8	Global Fixed 4.3	TIPS -8.6	Dev. ex-US -3.9	EM Fixed -12.3	TIPS 4.1
	Inv. Grade 2.4	Inv. Grade 4.3	High Yield 2.3	Global RE -48.9	Inv. Grade 5.9	Municipals 2.4	Natural Res. -12.5	Inv. Grade 4.2	EM Fixed -9.0	EM Fixed -5.7	EM Equities -12.6	Global Fixed 3.5
	Global Fixed -4.5	TIPS 0.4	Global RE -4.7	EM Equities -53.2	Cash 0.1	Cash 0.1	EM Equities -18.2	Cash 0.1	Gold -28.3	Natural Res. -7.2	Natural Res. -17.2	Cash 1.3

Source: Bloomberg, Northern Trust Investment Strategy. Gross total returns in USD. Year-to-date column through 8/31/15. Indices shown are preferred Investment Policy Committee proxies; 60/40 = 60% MSCI ACWI & 40% Barclays US Agg Bond Index; risk-control assets in shades of green; CAGR = Compound Annual Growth Rate (trailing 10 years through 8/31/15).

# Correlations

## Correlation USD – Total Return %

Asset Class	Proxy Indexes	Barclays Global Aggregate TR USD	Barclays US Corporate High Yield TR USD	MSCI World IMI GR USD	MSCI EM IMI GR USD	S&P Global Infrastructure TR USD	Bloomberg Commodity TR USD	NCREIF Property – UNSMOOTHED
Global Fixed Income	Barclays Global Aggregate TR USD	<b>1.00</b>	0.36	0.40	0.44	0.55	0.45	(0.22)
US High Yield	Barclays US Corporate High Yield TR USD	0.36	<b>1.00</b>	0.77	0.74	0.73	0.50	0.50
Developed World Equity	MSCI World IMI GR USD	0.40	0.77	<b>1.00</b>	0.88	0.92	0.61	0.45
Emerging Markets Equity	MSCI EM IMI GR USD	0.44	0.74	0.88	<b>1.00</b>	0.86	0.65	0.42
Infrastructure - Public Global Listed	S&P Global Infrastructure TR USD	0.55	0.73	0.92	0.86	<b>1.00</b>	0.62	0.41
Commodities - Futures	Bloomberg Commodity TR USD	0.45	0.50	0.61	0.65	0.62	<b>1.00</b>	0.37
Real Estate - Private Core	NCREIF Property – UNSMOOTHED	(0.22)	0.50	0.45	0.42	0.41	0.37	<b>1.00</b>

Source: Northern Trust

Note: The correlation has been calculated over the last 10 years (through June 30 2015)

# Alternative Asset Classes

## Real Assets

- Infrastructure, timber, agriculture etc.
- Can provide good long term inflation protection
- May not be particularly liquid

## Other non traditional equity and debt exposures

- Private equity, distressed debt, insurance linked securities etc.
- Typically expected to deliver a return premium and/or diversification
- Liquidity varies

## Hedge Funds

- Not an asset class; heterogeneous
- May involve significant leverage
- Intended to deliver returns based on manager skill rather than asset class exposure
- High fees

# Diversification

'There is no free lunch but diversification is definitely a cheap lunch'

## *Caveats:*

- Correlations **increase** in times of market stress
- Diversification only **works if done by risk factors**, not asset class labels
- The **broader** the range of exposures considered the more **effective** diversification can be.

# Investment Strategy for a DB plan

## Fundamental Questions:

- The funding position of the plan
- The strength of the employer covenant and the tolerance of the employer for volatility of contributions
- The extent to which the fund seeks to match the liability cashflows and if applicable, how this is done

### Balanced portfolio (e.g. 60/40 equities/debt)

- The traditional approach
- No attempt to match liability cashflows
- Long term returns may be good but also volatile
- Funded position of plan impacted by changes in interest rates.

### Immunised portfolio (using physical bonds)

- Portfolio consists wholly of bonds designed to match as closely as possible the liability cashflows
- Funding position is largely immune to changes in interest rates
- Perfect matching is not generally possible and this approach is not typically used by UK pension funds.

### Liability driven approach (using swaps)

- Portfolio comprises two segments: a **swaps portfolio**, designed to protect against interest rate and inflation risks, and a **physical assets portfolio**, designed to achieve strong long term returns
- Increasingly used by large funds, particularly if they are underfunded.

# Implementing Investment Strategy

## Active vs Passive Strategy

- Active managers seek to beat the designated benchmark while passive seek to match the benchmark
- Significant trend towards passive management: passive involves much lower fees; traditional active strategies often fail to consistently beat the benchmark net of fees

## Selection of asset class benchmarks

- Traditional approach: market cap weighted benchmarks e.g. FTSE; S&P 500
- Increasingly funds are using more sophisticated benchmarks including ESG benchmarks and 'smart beta'
- Smart beta involves managing to benchmarks defined according to specific factors e.g. value; volatility; dividends; quality etc.

# Key Takeaways

- Developing and implementing an **appropriate investment strategy** is fundamental to the long term viability of a pension plan
- **'True' diversification** (across risk factors not asset class labels) is key to an effective investment strategy
- Investment strategy for a DB plan needs to be considered in conjunction with the funded position of the plan, the strength of the employer covenant and the tolerance for volatility of contributions
- An **explicit decision** should be made about the extent (if any) to which a liability driven investment strategy should be used
- Implementation of investment strategy should include careful consideration of the merits of:
  - ◆ Active versus passive approaches,
  - ◆ Use of non market cap benchmarks and related approaches (often known as 'smart beta')
  - ◆ Incorporation of ESG principles.

# Important Information

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