

# PENSIONS *matters*

EDITION 12 JUNE 08



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## ALLOCATING YOUR EQUITIES

### MAXIMISE YOUR RETURNS WITH REDUCED RISK



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Why do most pension schemes invest in equities? The answer is simple: they wish to capture the extra returns that equities are expected to deliver relative to the lower-risk asset, gilts, over the long term. Equity investment increases the risks for a pension scheme but they accept this rocky journey as a compromise for the expected additional long-term returns. (For investment purposes, higher “risk” means returns from year to year are more variable, termed as investment volatility.)

However, are your pension investments structured to capture this excess return in the least volatile way? Many pension scheme equity portfolios have a strong bias to UK equities, sometimes as high as 70% of the equity assets. We are all comfortable with UK equities because they are denominated in the same currency as the benefits and give pension scheme trustees and employers a greater level of comfort. However, this comfort should not be interpreted as a safer equity approach; the over-reliance on UK equities actually increases risk within the investments.

We are going to explain why diversifying away from UK equities is a better way to capture the excess returns expected from equities.

# The problem with a high UK equity weighting



A fundamental principle behind investing is diversification. It is wise to spread risk and look to different return sources, rather than putting all your eggs in one basket. The danger from relying too much on one source of return was particularly evident between 2000 and 2003, when global stockmarkets almost halved in value and pension schemes with equity reliant investments suffered badly.

The UK stockmarket has become increasingly concentrated, and its success is now dependent on key industries such as Banks and Oil. The ten largest stocks now form 40% of the FTSE 100 index. For some pension schemes, this could result in a 15% exposure to UK Oil companies alone. Such a high weighting represents a disproportionate allocation of risk and as a result pension investments are likely to be more sensitive to the global oil price, or how the UK banking system fares, than one would like.

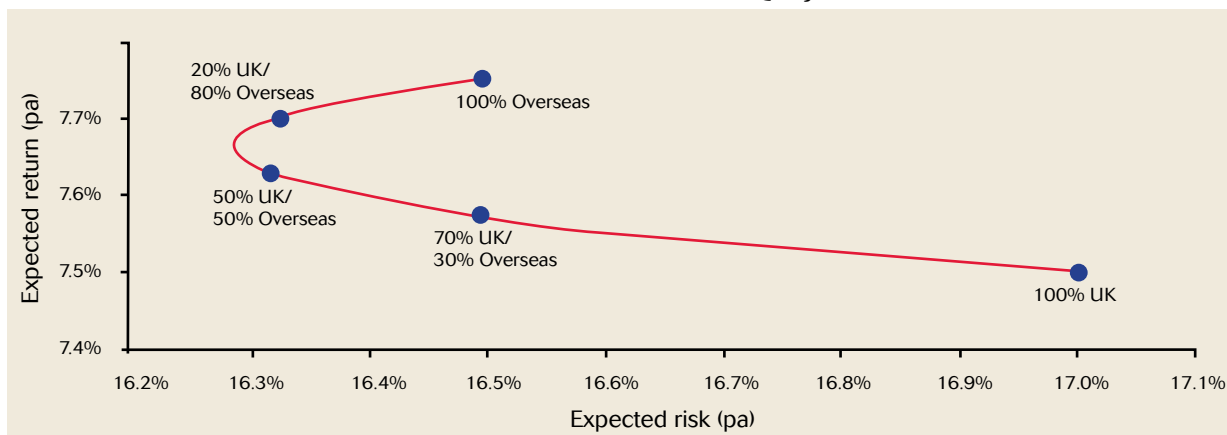
## SO WHAT IS THE ANSWER?

Increasing the allocation to overseas equities reduces the level of concentration, and hence risk, in an equity portfolio. Higher weightings to overseas equities reduce the exposure to specific countries or industries or stocks significantly.

On an intuitive basis, it feels safer to hold 5% rather than 15% in UK Oil companies to diversify risk. At a theoretical level, we can demonstrate the benefits of diversification in the chart below.

The chart shows the expected risk (x axis), defined as the standard deviations of returns, and expected return (y axis) for different passive UK/overseas equity portfolios, all in sterling terms.

ILLUSTRATION OF DIFFERENT UK/OVERSEAS EQUITY ALLOCATIONS



# Investment is all about striking balances, such as accepting investment risk within the pension investments to target a higher level of return.

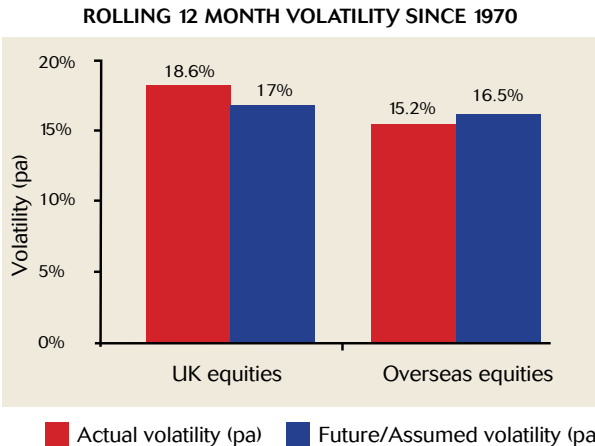
These portfolios have been modelled using certain assumptions for future returns, equity volatility and UK/overseas equity correlations, which modify the patterns seen in historic data to allow for sensible expectations of the future (such as the increasing correlation within global stockmarkets).

It is clear from the graph that a more diversified portfolio offers a better risk and return trade-off and we can see that the optimal allocation to overseas equity is around 50%-80%. Allocations to overseas equities in excess of this amount start to become less "efficient", as the increased currency volatility, which arises from the overseas investments, starts to outweigh the diversification benefits.

## IS THE EXPOSURE TO OVERSEAS CURRENCIES A PROBLEM?

Investment is all about striking balances, such as accepting investment risk within the pension investments to target a higher level of return. Investment in overseas equities requires balancing the diversification benefit with the downside of extra volatility through currency movements. The modelling on the previous page shows that the diversification benefits win through for overseas equity allocations up to 80%, and even then the downside is minimal for greater allocations.

The assumptions about the diversification benefits of overseas equity investment used in the earlier modelling are actually a lot more conservative than the levels of historic diversification that we have seen over the last 40 years. The chart below shows the annual volatility of returns in sterling terms from the UK and overseas stockmarkets (represented by the FTSE 100 and MSCI World, respectively) since 1970.



The overseas equity volatility includes the extra volatility that comes from currency movements. Despite this, overseas equities have been around 3% pa less volatile than UK equities in this time period due to the diversification benefits. We have also shown different future assumptions for volatility, which highlight a more conservative approach. This largely reflects the view that although global stockmarkets have become more correlated, overseas equities will continue to provide strong diversification benefits.

For defined benefit schemes, additional comfort can be taken when consideration is given to the risk of overseas equities relative to movements in liabilities, which in effect are the ultimate benchmark. We have found that the volatility of overseas equity returns is broadly comparable to that of UK equity returns when compared to a pension scheme's liabilities, and as a result there is no material change to the expected risk relative to the ultimate benchmark from an increased overseas equity allocation.

However, we should not lose sight of the fact that currency movements can be volatile in the short-term and they can significantly affect overseas equity returns. It is not uncommon for a 10% positive/negative movement in a currency to occur in a quarter. This would have a 10% impact on the overseas equity return for that particular country. As pension investments tend to have a long-term horizon, the potential short-term volatility should be bearable in most cases, given the sizeable diversification benefits.

**DO THE ARGUMENTS STILL HOLD FOR ACTIVE MANAGEMENT?**

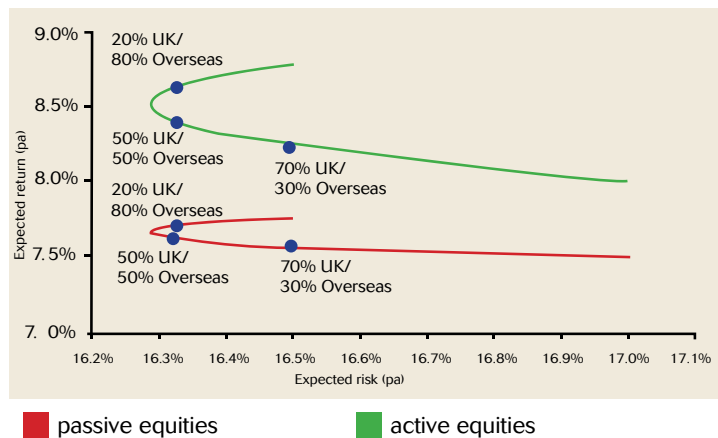
So far, to assist with the theoretical explanation, we have focused on the equity allocation assuming passive investment. The diversification arguments from higher overseas equity weightings still hold under active management, and actually the case is stronger under an active approach for the following reasons.

- *Active equity managers have been able to deliver strongest outperformance when they are given the widest possible universe of stocks from which to choose. Giving fund managers full licence to invest anywhere in the world without any geographical constraints also intuitively feels right as the managers are in the best position to make judgements about the relative merits of different countries. These managers are also able to take advantage of potential opportunities in emerging market economies such as India and China when appropriate.*
- *The more skilful fund managers now look at the investment world from a global viewpoint anyway, and invest their money accordingly. As a result, these managers arrange their research to look at industries on a global, rather than regional basis; for example, they will compare the relative merits of Shell and BP to Exxon or ChevronTexaco on a global basis. It also appears that managers are increasingly moving away from the regional equity model, as this they believe it is a sub-optimal way to capture potential outperformance.*
- *The chart below sets out the level of outperformance that the top quarter of global equity managers delivered above their index in the three years to 31 December 2007, compared to the outperformance from UK equity managers.*

It could therefore be argued that the potential diversification and increased return benefits from active global equities more than outweigh the downside from increased currency volatility. Just as important, for defined benefit schemes, there is very little change in the risk relative to a scheme’s ultimate benchmark, the liabilities, by investing in active global equities.

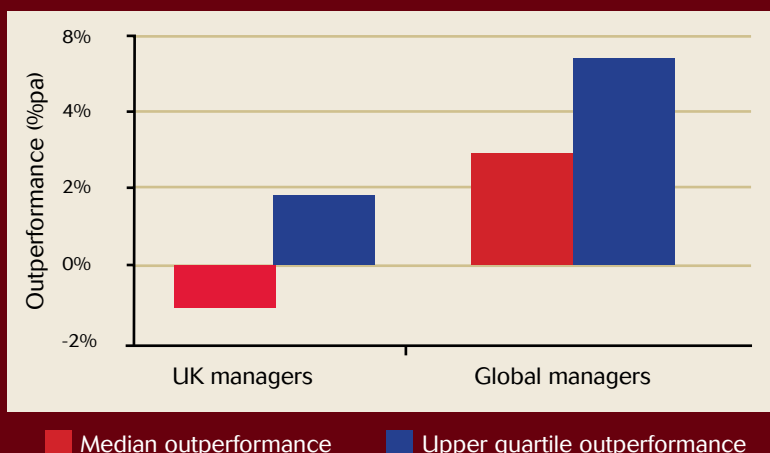
As a result, pension scheme equity portfolios could invest solely in global equities on an active basis, which would result in an exposure of 10% to the UK currently. In graphical terms, this is how the previous risk/return graph would change.

**ILLUSTRATION OF DIFFERENT UK/OVERSEAS EQUITY ALLOCATIONS**



The green line shows different UK/overseas weightings for actively managed portfolios. The chart shows that the introduction of active management increases the level of expected return without any material change to the level of risk.

**AVERAGE OUTPERFORMANCE OVER THE 3 YEARS TO 31 DECEMBER 2007**



The chart demonstrates that there is potential to gain outperformance from the UK but the scope for additional return, and the probability of it, is higher when investing in active global equities without geographical constraints.

Source: Bloomberg and Mellon Analytical Services Europe Limited

**THE ACTIVE/PASSIVE SPLIT**

The split between active and passive management is specific to each trustee board, and takes into account numerous scheme specific considerations. We believe that active management within equities has a role to play in reducing expected risk within pension investments. The table below sets out the expected risk and return for different asset mixes, and demonstrates how active management can help reduce overall investment risk within a portfolio. Each portfolio has the same expected return of about 6.5% pa.

| PORTFOLIO  | EXPECTED RISK (% PA) |
|--|----------------------|
| 70% equity/30% bonds (all passive)   | 11.8                 |
| 20% passive equity/40% active equity/40% bonds (equities more diversified) | 11.1                 |
| 50% active global equities/50% bonds                                       | 10.4                 |

**ACTION FOR SCHEMES**

There is no exact science when it comes to choosing the exact split between the UK and overseas parts of an equity portfolio. However, diversification and seeking outperformance in a sensible risk-controlled way are fundamental principles that should underlie how pension scheme investments are constructed.

We recommend that trustees consider whether they want to:

- *increase their overseas equity exposure*
- *target overseas equity active management without placing geographical constraints on their managers.*

The next step would be for trustees to talk these issues through with their consultants as part of a meeting focusing on scheme investment alone. Following these discussions trustees can make informed decisions with regard to any changes required to their pension fund equity holdings.



# Action for schemes



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