

## Expert View

# Fit for purpose

## Ashish Kapur says pension funds should exercise portfolios with dynamic asset allocation

When it comes to high-level asset classes, trustees are most comfortable with equities; bonds are boring as they have limited upside while hedge funds are perceived to be dangerous. Other alternatives, such as commodities, merit a small allocation for diversification. However, recent research demonstrates these views should not be etched in stone.

The *Barclays Equity Gilt Study 2011* confirms the long-term superiority of equities over other asset classes, with UK equities delivering a real return of 5.1%pa over the last 111 years. Gilts, on the other hand, delivered a paltry 1.2%pa after inflation. But over the last ten years those numbers are very different. From 1 January 2001 through 31 December 2010, equities produced a real return of 0.6% compared to gilts' 2.4%.

This finding highlights first, equities are likely to outperform over the long-term. Second, over short periods of time equities can be volatile and underperform all other asset classes. SEI's in-house research shows that in order to benefit from equity outperformance a minimum holding period of 20 years is needed.

Maintaining a significantly greater allocation to equities versus gilts over the past ten years cost many pension schemes. As many UK schemes are underfunded, trustees are conscious how important it is to take advantage of opportunities and protect against risk. This concern is causing trustees to take a fresh look at asset allocation and managing their investments.

In a survey conducted by SEI, 67% of trustees and finance directors said they are considering making asset allocation decisions this year, and 70% are looking to change the way they manage schemes<sup>1</sup>.

Historically, trustees set strategic investment policy for 3-5 years with infrequent changes;

that many are planning changes this year is telling. The traditional, static approach to asset allocation was a product of management structures revolving around quarterly meetings and separation of advisers and implementers. With fiduciary management becoming popular, trustees now have the option to be more active in asset allocation changes.

Trustees who use fiduciary managers can separate small portions of their portfolios and implement a dynamic asset allocation strategy within them. The separate portfolio can then overweight or underweight asset classes which the manager expects to add or detract from value over the short to medium term.

It is important to note these decisions should not be confused with tactical asset allocation (often a leveraged approach to make very short term decisions with high levels of risk). Instead this approach aims to manage asset allocation without leverage and is cognisant of the scheme's liability and trustee risk budget.

Given the availability of resources to actively manage scheme portfolios in a risk-constrained way, there is no reason for trustees to stick to the buy-and-hold equities strategy anymore. Trustees need to consider all approaches to improving funding levels; being inactive could lead to schemes becoming unhealthy.

*This article reflects the views of the individual author and does not necessarily represent the house views of SEI.*

<sup>1</sup>The Top Priorities for UK Pension Scheme Sponsors in 2011, SEI's Pension Management Research Panel (February 2011)

