Investment Strategy and Diversification

Core satellite approach a dud

Thomas Hauser

In recent years, many pension funds have added new asset classes to their strategic allocations. The goal is to improve diversification. However, this hodgepodge of investments not only fails to deliver, it also costs a lot.

In the past, the strategy of a typical pension fund consisted of liquidity and Swiss bonds as anchors of stability in nominal terms, and equities and real estate as drivers of returns in real terms. If you believe today's studies and expert advice, this is outdated. But is this really the case?

Alternative investments, politically driven

Looking at the average pension fund today, one finds a variety of relatively new asset classes, each with a modest but gradually increasing weighting. A look at the allocation of the representative UBS Pension Fund Index at the beginning of 2024 confirms this: 2.1% hedge funds, 4.1% private equity, 1.8% infrastructure and 1.3% commodities (see table). How did this hodgepodge of alternative investments evolve historically?

After the bursting of the monumental dotcom bubble at the beginning of the century, pension funds were receptive to the promises of marketing artists: Hedge funds promised to avoid the recently suffered equity losses, and private equity promised more attractive returns than publicly listed equities.

As a result of the financial crisis that followed a few years later (2007 to 2009), interest rates fell so low that pension funds began to look for alternative sources of returns. This is how infrastructure investments came onto the radar. At the same time, financial lobbyists in Bern managed to expand the nonsensical investment corset according to BVV2 to such an extent that it almost sounded like an official recommendation to actually invest in the permitted alternative asset classes. Authorities like such guidelines because it's easier to check quantitative admissibility than economic suitability.

These BVV2 provisions (in particular Art. 53 and 55) should be abolished and replaced by a "Prudent Investor Rule": Permissible is what is appropriate – those responsible determine this independently. If they act incompetently, they bear the liability.

Nothing but costs

What has this hodgepodge of alternative investments achieved in terms of diversification? To examine this, the returns and risk are calculated over 20 years using monthly data and a simplified allocation of the UBS Pension Fund Index (from early 2004 to late 2023) (see table). Fixed-income securities are allocated to Swiss bonds, and infrastructure is split equally between hedge funds and private equity due to a lack of long-term data. This makes sense in terms of risk and returns. Over this period, the annual returns are 4.53% and the volatility is 6.15%.

The almost 10% of alternative investments are now allocated to CHF bonds and Swiss equities to achieve the same returns (Variant A) or risk (Variant B) as the alternative investment allocation.

In Variant A, despite the apparent reduction in diversification with fewer asset classes, the risk can be lowered from 6.15% to 5.67%. This is not surprising, as the investments are subject to the same economic cycles.

In illiquid assets such as private equity or directly held real estate, fluctuations only seem lower because there are no constantly observable market prices. The risk of economic loss is therefore no lower. An example: The volatility of indirect real estate is 8.4%, while that of direct real estate is an unrealistic 0.6% due to the accounting smoothing of the estimated values – only a fool would believe they are safer with direct real estate in a real estate crisis. The same applies to other illiquid assets.

You can also increase the returns for the same risk by omitting alternative investments (Variant B): The annual return then rises from 4.53% to 4.75%. Over 20 years, this will result in an increase in wealth of around 10%. But this is only half the truth. After costs, the difference in final wealth after 20 years is a staggering 25%.

Risk and Return with and without Alternative Investments

Asset class	UBS PK Index Jan. 2024	Simplified allocation of the UBS PK Index	*Variant A Same returns	**Variant B Same Risk	Data series used
Cash	3.75%	3.76%	3.76%	3.76%	Money market rates 3M
Bonds (incl. mortgage-backed)	34.19%	34.27%	38.90%	34.27%	Swiss Bond Index
Swiss equities	9.35%	9.37%	14.00%	18.62%	SPI
Equities abroad	19.76%	19.81%	19.81%	19.81%	MSCI World net
Real estate direct	9.17%	9.19%	9.19%	9.19%	KGAST Index
Real estate indirect	14.31%	14.34%	14.34%	14.34%	each ½ WUPIX A und F
Hedge funds	2.09%	3.00%	–	–	HFRX Global HF
Infrastructure	1.80%	–	–	–	–
Private equity	4.08%	4.99%	–	–	LPX Direct Listed PE
Commodities	1.26%	1.26%	–	–	S&P GSCI
Other	0.25%	–	–	–	–
	100.0%	100.0%	100.0%	100.0%	
2004–2023					
Returns per annum		4.53%	4.52%	4.75%	
Volatility		6.15%	5.67%	6.12%	
Worst month		–8.23%	–6.96%	–7.08%	
Best month		5.85%	4.54%	4.89%	

* ½ of the alternative investment is allocated to Swiss equities and the other ½ to bonds.
** The weighting of the alternative investments is allocated to Swiss equities.

Why is this? The manageable proportion of alternative investments has a significant impact on costs: The asset management costs for a strategy with alternative investments are estimated at 0.66% p.a. and without alternative investments at 0.31%.[1] The allocation of almost 10% to alternative investments thus doubles the costs.

In this respect, the core satellite approach is a dud: What's the point of paying attention to cost effectiveness for traditional investments when there is a massive cost disadvantage for alternatives? This can hardly be justified by good diversification or higher returns, as the above calculation shows.

[1] According to the c-alm document "Cost Transparency in Capital Management" dated 7 September 2023, a cost rate of 0.2% p.a. is assumed for mandates of CHF 20 million for equities and bonds. The cost rate of 0.7% for property is based on the TER for typical Swiss real estate investments. 5.0% is assumed for private equity, based on the 5-6% range mentioned by PPCmetrics in FuW in October 2017, and the same applies to hedge funds. In the case of infrastructure, a survey of pension funds revealed a cost rate of 2.5%. 1.5% is assumed for commodities. To validate the overall cost rate, reference is made to a statement by Iwan Deplazes, Head of Asset Management at ZKB, indicating that the average asset management costs were 0.54% ("NZZ", 15 November 2023). This is consistent with the 2019 c-alm cost study, which shows a total cost of 0.5%.

SCHWEIZER PERSONAL VORSORGE
PREVOYANCE PROFESSIONNELLE SUISSE

What are the implications for the strategy definition of pension funds?

- An investment strategy should be based on transparent asset classes for which there is historically verifiable evidence of risk and returns characteristics. Listed equities are the undisputed driver of returns. Good Swiss bonds outperform alternative investments when it comes to long-term solid diversification. Their correlation with equities over the observed period is also significantly lower at 0.16 than with private equity at 0.80 or hedge funds at 0.68.
- Asset classes that meet this basic requirement should be used with conviction, ideally with at least 5%. Otherwise, the complexity of the implementation will only increase without achieving any effect.
- Investing in illiquid assets on the basis of diversification does not work in most cases. It is an accounting pseudo-diversification based on smoothed “net asset value” estimates.
- Investment managers should recognise that avoiding unnecessary complexity helps to reduce costs and dependency on consultants and providers.
- The asset class specifications according to BVV2 are neither a recommendation nor an indication of meaningfulness.
- Even if the marketing for an asset class sounds good, investment managers must always ask themselves whether they would make the same investment with their personal assets. Who would sign a draconian contract for their own money at a cost of 2% to 5% a year for ten years or more?

TAKE AWAYS

In recent years, many pension funds have expanded their engagement in alternative investments and infrastructure.

This often morely achieves accounting diversification due to delayed model valuation – in terms of return and risk, the investments bring no added value.

The cost of a portfolio with alternative investments is twice that of a portfolio without them.

Thomas Hauser
Dr. rer. pol., Managing Partner, Dr. Pirmin Hotz Vermögensverwaltungen AG