Hedge funds not asset class, schemes advised

David Rowley

Cardano has taken a 30% position in hedge funds across its fiduciary clients and believes these strategies should be viewed tactically rather than as an asset class.

The fiduciary manager, which manages portfolios for Asda, Express Newspapers and Pirelli pension schemes, has built up the position largely in global macro strategies, focusing on emerging markets, volatility and commodities. The allocations are spread across approximately 10 hedge funds.

Keith Guthrie, its chief investment officer, said: "We view hedge funds as a tool, not a separate asset class. Many pension funds say they have 5% in hedge funds and view it as a separate asset class, but they should think about allocations in the context of their whole portfolio, where they can improve risk-reward."

Seeing hedge funds as a tool – for example to balance out risks in equity holdings – has led Cardano to only use single–manager hedge funds against the industry trend for funds-of-hedge funds.

But the use of multiple single strategies poses additional governance hurdles for pension funds, with each complex strategy requiring due diligence.

Patrick Bloomfield, head of trustee solutions for Hymans Robertson, said: "Single–strategy hedge funds give Cardano much greater clarity on which positions they are taking and when, why and how they control them.

"But you could argue a fiduciary manager, in having several single-strategy hedge funds, is acting as a fund-of-hedge funds themselves."

Guthrie: views hedge funds as a tool rather than a separate asset class

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Cardano's view is not far off another fiduciary manager; P-Solve chief investment officer, Glyn Jones, said: "The problem with the term 'hedge funds' is that it covers a multitude of sins. Most don't really work as a diversifying asset class." He favours hedge funds that offer short equity exposure.

"These are generally not good long-term investments but can add significant value if used more tactically," he explained. "Within this view of the hedge fund universe, we have been advising clients to use them since our inception in 2001."

Investment insight

Tim Banks
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Taking a different approach to DC

For at least the past 15 years the conventional wisdom in defined contribution (DC) investment default design has been to use a lifestyle strategy. This sets the strategic asset allocation to derisk a member's savings as their individual risk capacity diminishes through time – a pretty sensible approach.

On a practical level, however, the delivery of the default using lifestyle approaches is less than ideal. They are typically inflexible and notoriously difficult to change, with the strategy being run on an individual basis. The strategies employed in the lifestyle default are often overly precise, and very end-point sensitive, targeting a precise retirement date and assuming the member will buy an annuity the very next day.

This inherent inflexibility often leads to the use of a single manager or asset class, which limits diversification and introduces single manager risk.

The problems extend to communications with members; you would not find many who understand the lifestyle approach and, more significantly, the importance of that strategy as they move towards crystallisation. So is there anything better we should consider?

What if we could improve on this for both member and sponsor, providing a more flexible, diversified and sophisticated default that can quickly react to changing circumstances?

There are plenty of reasons to consider a different approach for the default fund right now: auto-enrolment, changing retirement patterns, a volatile investment environment, and changing regulation are all catalysts for change. No one would argue the current model for the governance of DC default funds is robust, with the fiduciary typically responsible for setting the investment objectives and also managing the assets.

Used thoughtfully, a flexible target date approach can address many of these concerns. In doing so it can be designed on a bespoke basis for a client, using their best investment ideas (open architecture), yet with the flexibility to change strategy or fund components easily, and be simple for members to understand.

Right now the ability of the portfolio manager to apply volatility management techniques across the various funds involved is more important than ever. The fact that diversification and dynamism can be incorporated without the need to disrupt members is a clear and considerable advantage.

When added to the benefits of its stronger governance, flexible target date funds provide a compelling alternative to the traditional approach.

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