Citi OpenInvestor™

Asian Pensions & the Road to Alternative Investments
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Faced with rapidly aging populations, increasing contributions and volatile markets, pension funds in Asia continue to look to alternative investments as a source of noncorrelated returns. However, alternative investments do not come without extensive challenges. Compared to researching traditional managers, investment evaluation, operational due diligence and ongoing administration and monitoring of alternative managers can be much more complex.

That being said, more and more pension funds are considering alternative investments, and for good reason: A recent report from The Centre for Hedge Fund Research at Imperial College in London found that between 1994 and 2011, returns from hedge funds (9.07% on average after fees) and commodities (7.27%) bested returns for global stocks (7.18%) and global bonds (6.25%).

Institutional interest in alternatives is quite strong in Asia, yet one must distinguish between pensions and sovereign wealth funds (SWFs). According to Cerulli Associates, Government of Singapore Investment Corporation (GIC), for example, is in its own right one of the largest real estate investors in the world, and is considered a highly sophisticated backer of hedge funds and private equity. Similarly, the chief investment officer (CIO) of Korea Investment Corporation (KIC) has remarked that 20% is a good ceiling for alternative investments in its portfolio. But generally, SWFs tend to invest in long-duration, low-liquidity assets: Many are funded by some form of “found money” (trade surpluses, natural resources or privatization of state-owned enterprises), and have no explicit liabilities. Pension funds, on the other hand, are beholden to their obligations to retirees, which constrains not only which assets they invest in, but also the degree of illiquidity they are willing to accept. Historically, some pension funds have proceeded with caution, augmenting a generous allocation to sovereign debt with a dash of domestic equities.

The Case for Alternatives

Today, there are signs that Asian pension funds’ appetite for alternative investments is growing. The same demographic challenge plaguing the West – namely, an aging population – is even more acute in some Asian markets. In Japan, for example, people 65 years or older will account for 29% of the population in 2020, and almost 40% by 2040. At the same time, bond yields are near zero, and the Nikkei remains 75% below its 1989 peak. Citing these circumstances, Japan’s Pension Fund Association plans to allocate more to private equity and hedge funds.

While the Japanese have one of the longest life expectancies, other markets in Asia face similar challenges. The legacy of the “one-child” policy is one factor behind the United Nations’ (UN) projection that the elderly share of the Chinese population – currently at 178

3Ibid.
million — could reach 437 million, or one third of the population, by 2050.\(^5\)

And if emerging Asia has enjoyed better stock market performance than Japan over the past two decades, that doesn’t mean that retirees are well provided for. Recent estimates from research firm Strategic Insight suggest that while pension funding per capita runs at approximately $60,000 in Australia and $30,000 in Japan, China ($300) and India ($125) lag significantly behind.\(^6\)

Moreover, as the pension regulations have successfully resulted in the prefunding of retirement benefits, the ongoing volatility in global equity markets makes the diversification offered by alternative investments hard to ignore. During the past year as of April 30, 2012, the MSCI Japan index has fallen 5.4%, while the Pacific ex-Japan index has fallen 12.5%, and the All China index is down 15.5%, making alternatives an essential tool for pension funds to meet their return targets. Alternative investments could take the form of hedge funds designed to deliver absolute returns, or less-liquid investments, such as private equity, real estate and infrastructure assets, which may have the potential to outpace returns from listed equities and provide a long-term source of investment income.

Particularly for emerging Asia, the provision of formal retirement benefits for the first time is exciting, yet the short-term returns of pension funds are closely scrutinized, and headline risk is a key concern. That being said, pension funds that thoughtfully incorporate alternatives in their portfolios may be able to both dampen volatility and improve long-term returns.

**Investing in Alternatives: Special Challenges**

Investing in any asset class has its challenges, but investing in alternatives adds additional layers of complexity. Although there is significant change under way with current regulation, historically alternative managers were more lightly regulated than their traditional counterparts, which creates a caveat emptor construct – that is, regulators expect that only informed investors will seek out these products, and that these investors, rather than the regulators, will ask managers the critical questions.

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In spite of recent steps to increase regulatory oversight, some alternative managers argue that investors are savvy enough to know what they are doing, and that any regulatory intervention will only reduce investment opportunities, limiting current and future returns for the funds—potentially harming investors instead of helping them. Similarly, in a recent letter to the European Parliament’s Committee on Economic and Monetary Affairs, ten of the biggest Dutch pension funds with €500bn of assets said the proposed Alternative Investment Managers Fund Directive (AIFMD) would “have an undue negative impact” on their industry.\(^7\)

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\(^6\)“Fund Distribution in Asia,” webinar, Strategic Insight, March 28, 2012.

\(^7\)“Pension Funds Fear EU Hedge Funds Rules,” Financial Times, January 13, 2010.
“Any service interruption, failed technology, employee turnover or compliance violation could be just as serious, if not more so, than a failed investment idea.”

Recent changes notwithstanding, alternative products sold to professional investors remain more lightly regulated than traditional products, making proper due diligence crucial. On the investment side, this means establishing a firm understanding of the manager’s security selection process. By design, alternative strategies may not always move in lockstep with equity and bond markets, making due diligence more complex than on the traditional side. Since alternative managers will have more ability to short securities, use leverage and invest in illiquid securities, pension funds need to dig more deeply to ascertain both when and how these techniques might be used. For example, short position in Stock A could reflect the manager’s negative view on that security, or it could be a hedge against a long position in another stock in the same sector. A simple review of the portfolio holdings may be insufficient for understanding the manager’s strategy.

Pension funds should also consider focusing their attention on operational due diligence. At a minimum, this means pension funds should have an understanding of “key-man risk” and performing background checks on the funds’ portfolio managers, analysts and business leaders. It is also essential to test the firm’s trading capabilities, reviewing its compliance procedures and understanding the valuation policies in place. Beyond kicking the tires in the asset manager’s operation, pension funds must also look externally to vet the fund’s service providers, to determine their stability, independence and procedural discipline. Pension funds must understand that any service interruption, failed technology, employee turnover or compliance violation could be just as serious, if not more so, than a failed investment idea.

If the special risks of alternative investing seemed theoretical, recent events have highlighted the need for expertise when investing in these strategies. On February 24, 2012, the Financial Services Agency (FSA) in Japan suspended the operations of AIJ Investment Advisors Co., so that the regulator could investigate possible losses in the hedge fund. With ¥183 billion ($2.3 billion) in assets at the time of the FSA’s action, more than 80 pension funds were invested with AIJ. Most of these are small and medium-size pension funds which have traditionally relied on referrals, rather than using independent consultants to conduct proper due diligence and risk assessment.

While robust investment and operational due diligence are critical for alternative investments of all types, hedge funds, private equity, real estate and infrastructure each offer special challenges detailed below.

Hedge Funds
Hedge funds and private equity managers may offer limited liquidity and trade using esoteric investment techniques, including highly concentrated positions, shorting, the use of leverage and activist investing (or, in the case of private equity, actually changing the structure of

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the underlying companies). When hedge funds perform their own administration, investors should proceed with caution. A study by researchers at the University of Cologne showed that 25% of 864 hedge fund firms over the decade covering 1999 through 2008 exhibited "economically significant" differences in reported security prices compared to the actual prices. Importantly, some of these concerns can be reduced by utilizing an independent administrator that follows strict pricing guidelines.

**Private Equity**
Investments in private equity, real estate and infrastructure managers may also prove challenging for pension funds. By the very nature of the asset class – investing in underlying companies that do not trade on an exchange – private equity investing is less liquid. Moreover, even when compared to hedge funds, there are fewer standardized measures of risk and return. Fee and carried interest calculations differ substantially by manager and across regions. In addition, many managers are less open to providing detailed transparency in their reporting, or customizing that reporting to meet the unique needs of each institutional investor.

**Real Estate and Infrastructure**
Like private equity, real estate and infrastructure investments are often a long-term proposition. Returns will be highly correlated to the cash flows generated by these investments, yet those cash flows may be intermittent and highly unpredictable. Also similar to private equity, these investments will require investors to commit capital up front, with additional commitments to potentially follow, making liquidity management an issue for an investor's entire portfolio. "Most pensions are still getting weaned off investing in their own domestic fixed income markets," notes one real estate expert in Asia, and "have a general lack of understanding of real estate investments." Similarly, Thailand’s Government Pension Fund (GPF) announced plans in 2011 to expand its existing domestic real estate portfolio with offshore private real estate funds.

**Overcoming Challenges**
Despite the operational challenges, many pension funds have invested successfully in alternatives. Globally, institutions such as CalPERS, Ontario Teachers and the Dutch pension fund ABP are renowned for their use of alternative investments. On average, U.S. pension funds allocate around 25% in alternative asset classes.

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10Citi SFS research, April 2012.
11Cerulli Quantitative Update: China 2011.
and in Asia, a number of pension funds have either already invested in alternatives or announced plans to do so. For instance, in Korea, the National Pension Service has voiced plans to invest as much as $4 billion into hedge funds, private equity and infrastructure.14 As one observer notes, “The smart money has gone into hedge funds and the hot money has gone out.”15 And the Government Employees Pension Service currently has 16% allocated to alternatives, with plans to add an additional $160 million to these strategies.16

“Direct investing demands an extensive governance process and robust infrastructure.”

In China, NCSSF Chairman Dai Xianglong recently announced that the fund will raise its current RMB19.5 billion private equity allocation significantly over the next three years, after PE accounted for 70% of its total return in 2011.17 And Malaysia’s Employees Provident Fund, the world’s ninth-largest pension fund by assets, while describing itself as “cautious,” saw some of its largest gains in the third quarter come from its property investments.18

While these larger funds have been investing in alternatives for some time, many pension funds in Asia are now considering these investments for the first time. In structuring their alternative investments, investors historically had limited options. Although they might have had a choice between funds of funds (FOF) and direct investments, investors largely accepted off-the-rack products with little or no customization. Today, however, due in part to a more cooperative spirit of collaboration on the part of managers, consultants and service providers, pension funds have additional options on the table.

FOF: A Key Entry Point for Alternative Investing

For pension funds without significant internal resources, FOF may offer a turnkey solution, providing investment due diligence, operational due diligence and a well-diversified portfolio. While investing directly may sound like a less expensive way to get alternative exposure, the true price of direct investing goes beyond management fees. Direct investing demands an extensive governance process and robust infrastructure, including risk management and reporting systems, not to mention the price tag of the time and effort of manager evaluation.

Furthermore, for smaller pension funds, the ability to diversify and access prominent alternative managers can be an issue. Even for a $50 million pension fund willing to allocate 30% of its assets ($15 million) to alternatives, splitting that allocation equally ($5 million each) across hedge funds, private equity and real estate/infrastructure might enable the use of no more than five managers, (assuming $1 million minimum investment). Similarly, some prominent

14“Picking High-Hanging Fruit: Competition Intensifies Between Asian Managers and Foreign Firms,” Citi SFS, Mirae Asset, and Cerulli Associates, October 2011.
15“Picking High-Hanging Fruit: Competition Intensifies Between Asian Managers and Foreign Firms,” Citi SFS, Mirae Asset, and Cerulli Associates, October 2011.
18“Malaysia’s EPF Cautious Despite Opportunities,” Ignites Asia, December 21, 2011.
alternative managers have closed to new investors, but maintain preexisting relationships with FOF. Thus, by investing through FOF, pension funds can indirectly access managers whom they could not access directly.

Post-crisis, institutional investors have directed a lower percentage of flows toward FOF. Towers Watson recently reported that it awarded three times as many direct mandates to hedge funds last year as it did to funds of hedge funds; for private equity and real estate, the multiplier was four times and ten times, respectively.

Though some have suggested that FOF are a dying breed, FOF can still play a meaningful role for pension funds.

Indeed, FOF have shown a willingness to modify their offering post-crisis, restructuring fees and customizing their due diligence delivery. In addition to offering pension funds bespoke vehicles, some FOF are customizing their selection processes, or building completion portfolios around pension funds’ other existing investments. A recent example of this evolution is the decision of the $50 billion Massachusetts Pension Reserve Investment Management board to hire Arden Asset Management to oversee the movement of about $2.8 billion from four hedge funds of funds into about 20 individual hedge funds. Arden’s previous relationship as an FOF manager was terminated by MassPRIM in late March, when the pension system announced it would move to direct investments. Increasingly, the lines between FOF, consultants and service providers are blurring.

While we expect more interest in direct allocations to alternative managers, we do believe that the pendulum won’t necessarily swing 100% in the other direction. Indeed, the next major manager blowup could shift the balance of flows away from direct investments. But regardless of how the industry in aggregate moves, individual pension funds are likely to mix and match FOF with direct investments as they see fit.

Evolution in Vehicles: Managed Accounts and the “Fund-of-One”

Beyond the decision of whether to go direct or through FOF, pension funds are devoting more thought to the structure of their alternative investments. Rather than accepting their status as a limited partner in an off-the-shelf fund commingled with other clients (including retail investors), some pension funds have pushed for so-called “managed account” arrangements. Under this arrangement, the manager creates a separate portfolio for the institutional investor, with custody and administration conducted by providers of the client’s choosing, rather than the hedge fund or private equity firm. When the manager wishes to place a trade for the managed account, those instructions are routed to the custodian.

This approach offers clients a number of sizeable advantages: First, the investor owns the investments directly vs. an investment in a partnership interest; second, the administrator can provide full transparency of the portfolio at any time, possibly even in real time. Either through predetermined rules or ad hoc alerts, the client can also direct the custodian to reject individual trades that might violate the investment policy guidelines.

19 "Institutions Move Away from Hedge Funds of Funds,” Funds Europe, February 27, 2012.
Finally, because the account is a bespoke, the institution’s investment is not commingled with other clients, therefore reducing the counterparty and liquidity risk. Traditional limited partnership structures lump together pension funds with short-term-oriented high net worth investors. Whereas pension funds recognize that giving up some liquidity might improve long-term returns, redemptions on the part of retail investors can lead to forced selling, which might depress asset prices in the portfolio and lead to poor performance.

A similar option for pension funds to consider is the so-called “fund-of-one.” As the name suggests, the fund-of-one is structured like a typical hedge fund or private equity fund, but with only one limited partner. For the investor, this structure may offer many of the advantages of a managed account solution, including increased transparency and lower fees, as the terms are mutually agreed upon between the client and the manager. Moreover, the burden of identifying and engaging service providers that is required under the managed account structure falls upon the manager, just as it would in a “fund-of-many” (i.e., off-the-rack fund allowing multiple investors). One public pension plan sums it up nicely: “A fund-of-one is good because you don’t have the operational burden but you still get the legal segregation.”

**Evolution in Partnerships: New Advice Delivery**

Performance of alternative managers during the financial crisis has led many institutions to revisit the investment due diligence process. While investment due diligence was a key stated value proposition for FOF, performance of multimanager solutions was in many cases worse than expected: Funds of hedge funds actually lost 420 basis points more than the average hedge fund in 2008, suffering an absolute decline of 20%. Some market participants attributed this to the second layer of fees, while others argued that FOF guaranteed mediocrity by diversifying across 100 or more funds.

In the West, due diligence is increasingly being filled by consultants and other hedge fund advisors. For pension funds in Asia, one challenge is that the alternatives consulting industry is still evolving, especially outside of Japan and Australia. While regional data is hard to obtain, 2010 research from Greenwich Associates estimated that just 27% of institutions in Asia use investment consultants. A few homegrown players operate in emerging Asia, and dozens are active in Australia and Japan, due to the maturity of their pension markets. More recently, a few global investment consultants, such as Albourne Partners, Cambridge Associates, Mercer and Towers Watson, have bolstered their presence and expertise in the Asia region.

Asian pension funds are turning to banks and financial institutions as partners for additional advice, given the banks’ and FIs’ deep and extensive experience in advising alternative investments for wealth management solutions and the local expertise and presence. Clients may leverage the formalized research teams dedicated to alternative strategies to enhance operational and investment due diligence. Additionally, pension funds may also leverage banks to create tailored portfolios and multiasset products.

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21Ibid.
22Hedgefund.net, Cerulli Associates.
Finally, for pension funds who believe they can go it alone, help is coming in the form of growing databases on alternative strategies. Whereas databases of hedge funds, private equity and real estate managers in the West are well established, third-party resources are still a work in progress in Asia. U.S.-based eVestment Alliance is hoping to change that by working with local managers and partnering with both Cambridge and Towers Watson. However, most local managers have been providing details regularly and balk at providing this depth of information to anyone other than a current client. In markets such as China, where the regulatory framework is still evolving, some managers are reluctant to participate in such exercises unless they believe local and national authorities would fully support providing this level of transparency.

**Hands-On Investing: Leveraging Influence for Greater Transparency and Control**

Although new regulations, such as the Alternative Investment Fund Managers Directive (AIFMD) in Europe and the Dodd-Frank Act in the U.S., have mandated greater oversight of private funds, change is also being forged by influential investors and industry trade groups.

“The good news for pension funds today is that they have a wider array of choices.”

One such organization is the Institutional Limited Partners Association (ILPA), which is playing a significant role in improving transparency and is helping to direct the industry toward standardization. With over 250 members collectively managing over $1 trillion in private assets globally, ILPA has established operating guidelines to drive consistency in the manner in which GPs are reporting certain information to their investors. Its Private Equity Principles center around an alignment of interests, improved governance and increased transparency. While ILPA’s recommendations are nonbinding, CalPERS has formally announced that starting March 1, 2012, GPs will have to comply with its new ILPA-style terms on capital calls and distributions. Other large investors are using their size to change the terms of engagement. Co-investments allow institutional investors to have greater say in which deals and on what terms their managers invest. With $44 billion of its $110 billion total allocated to private investments, Texas Teachers has struck strategic partnerships with large private equity managers that “affords us greater flexibility and more control [and] the opportunity to closely inspect the practices of these firms and get a grasp for how they consistently outperform the public-equity markets.”

Given lower asset levels and competitive pressures, many alternative managers are demonstrating a willingness to collaborate on solutions that best fit the needs of their institutional clients.

**Pension Funds and the Future of Alternative Investing**

Given increased volatility, low yields and demographic pressures, alternative investments will offer tremendous appeal for pension funds in Asia for years to come. The good news for pension funds today is that they have a wider array of

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23 Institutional Limited Partners Association website.
choices in terms of the vehicles and service providers used to access alternative strategies. Equally important, alternative solutions can be tailor-made to fit the circumstances of the individual pension fund.

For smaller institutions investing in alternatives for the first time, FOF will continue to provide diversified, turnkey solutions. While larger pension funds are more likely to hire direct managers or make co-investments, they might at the same hire an FOF to focus on emerging managers, since a large direct allocation to two or three hedge funds might prove overwhelming.

The key point for pension funds in Asia is to recognize that the evolution in alternatives has at once improved the quality and quantity of solutions available. Consultants, FOF, banks and other service providers can provide assistance throughout the value chain, providing a platform of investment and operational due diligence, risk management and customizable reporting solutions. Moreover, an individual pension's approach may quite well embrace all of these options at different stages of its life cycle.

Post-financial crisis, one thing is clear: Pension funds’ investment in alternatives need not be a one-size-fits-all solution.
About Citi OpenInvestor℠

Citi OpenInvestor℠ is the investment services solution for today’s diversified investor, combining specialized expertise, comprehensive capabilities and the power of Citi’s global network to help clients meet performance objectives across asset classes, strategies and geographies. With an on-the-ground presence in over 95 countries and over $13 trillion in assets under custody, Citi offers award-winning service and unmatched scale. Citi provides complete investment services for institutional, alternative and wealth managers, delivering middle-office, fund services, custody, and investing and financing solutions focused on clients’ specific challenges and customized to their individual needs.

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