

# **TREND TOWARDS BONDS AND ALTERNATIVE INVESTMENTS**

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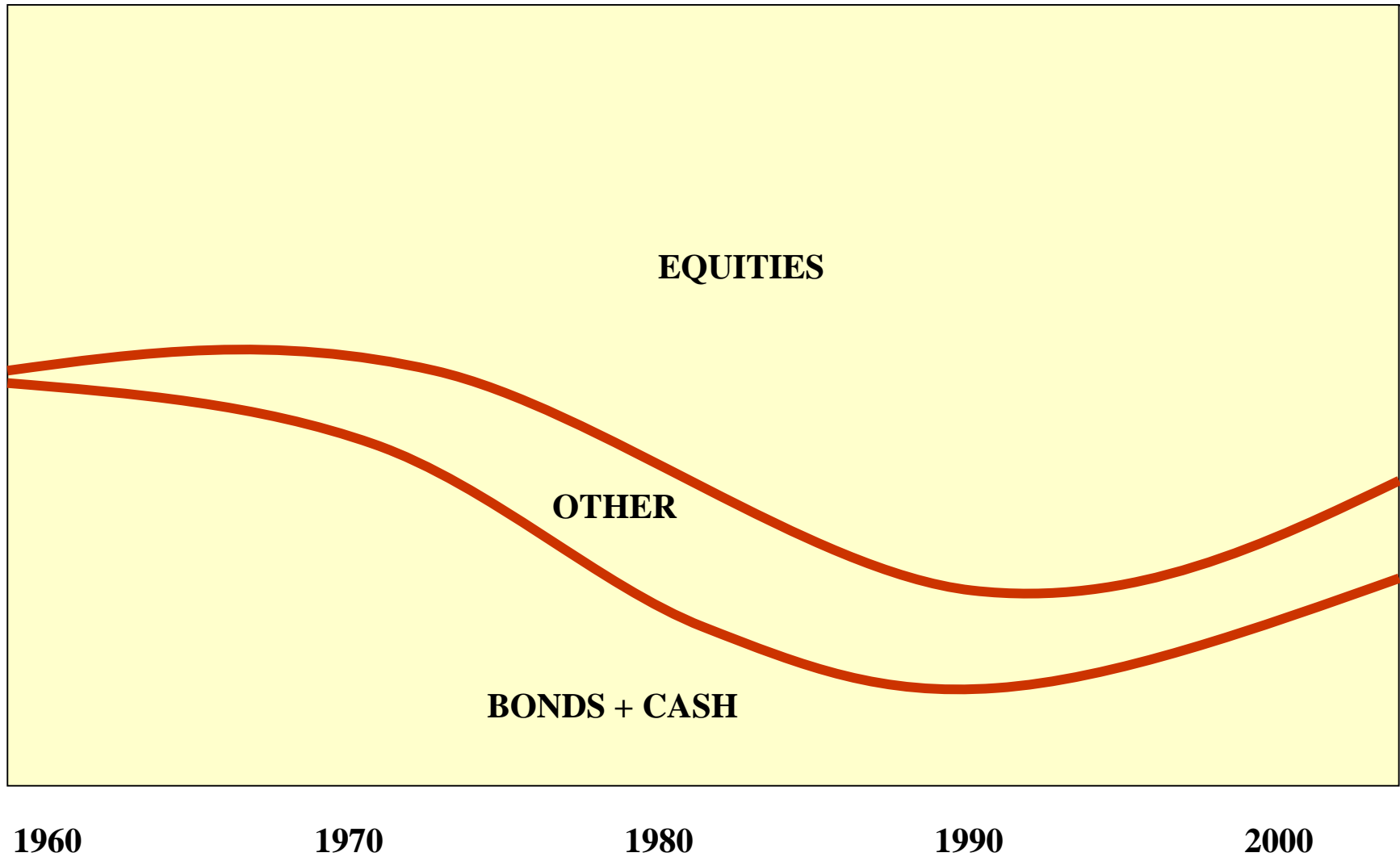
# UK pension environment

- Deficiencies in defined benefit plans
- Consumer protection
- Plan closures

# Investment policy response

- More asset matching to liabilities
- More in bonds, less in equities
- Seek lower risk and higher returns!
- Alternative assets can do this!

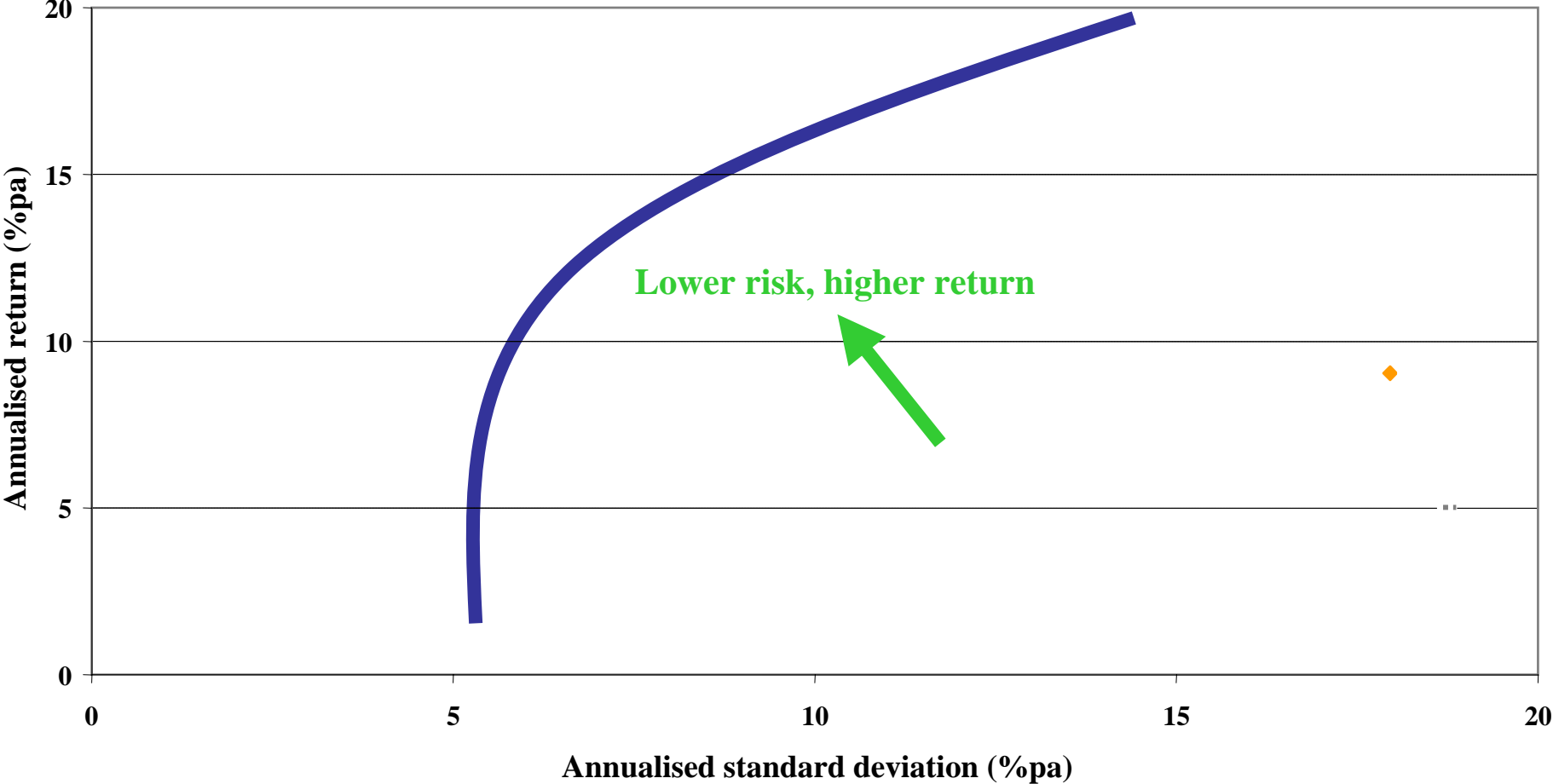
# Asset allocation history



# Alternative investments

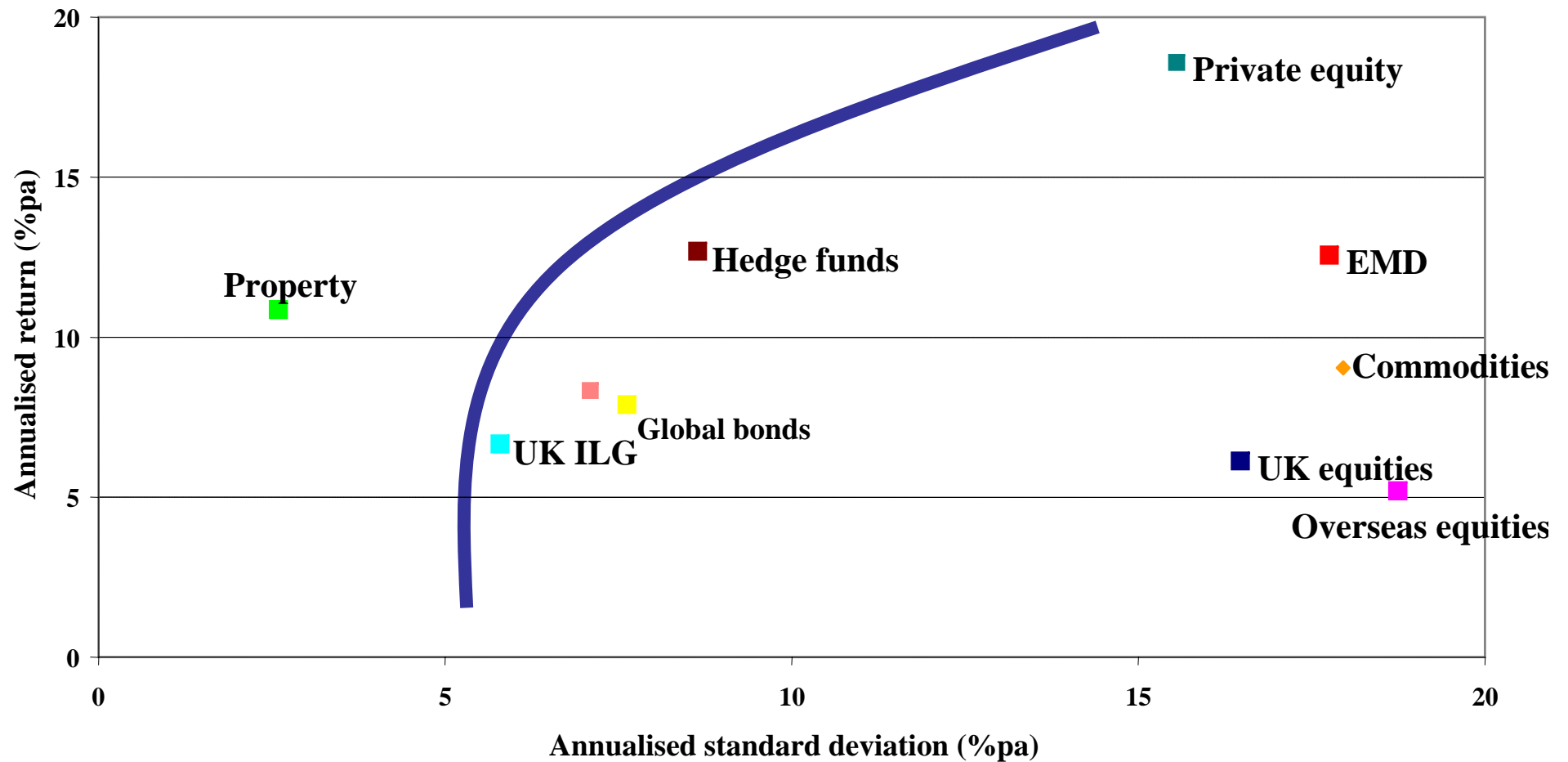
- Hedge funds
- Private equity
- Property
- Commodities
- Emerging market debt
- etc.....

# Risk and return



# Risk and return – historical data

10 years ending 31 December 2003  
based on quarterly data



Sources: FTSE, SB, ML, Venture Economics, HFR, JPM, IPD.

# Why are bond yields so low?

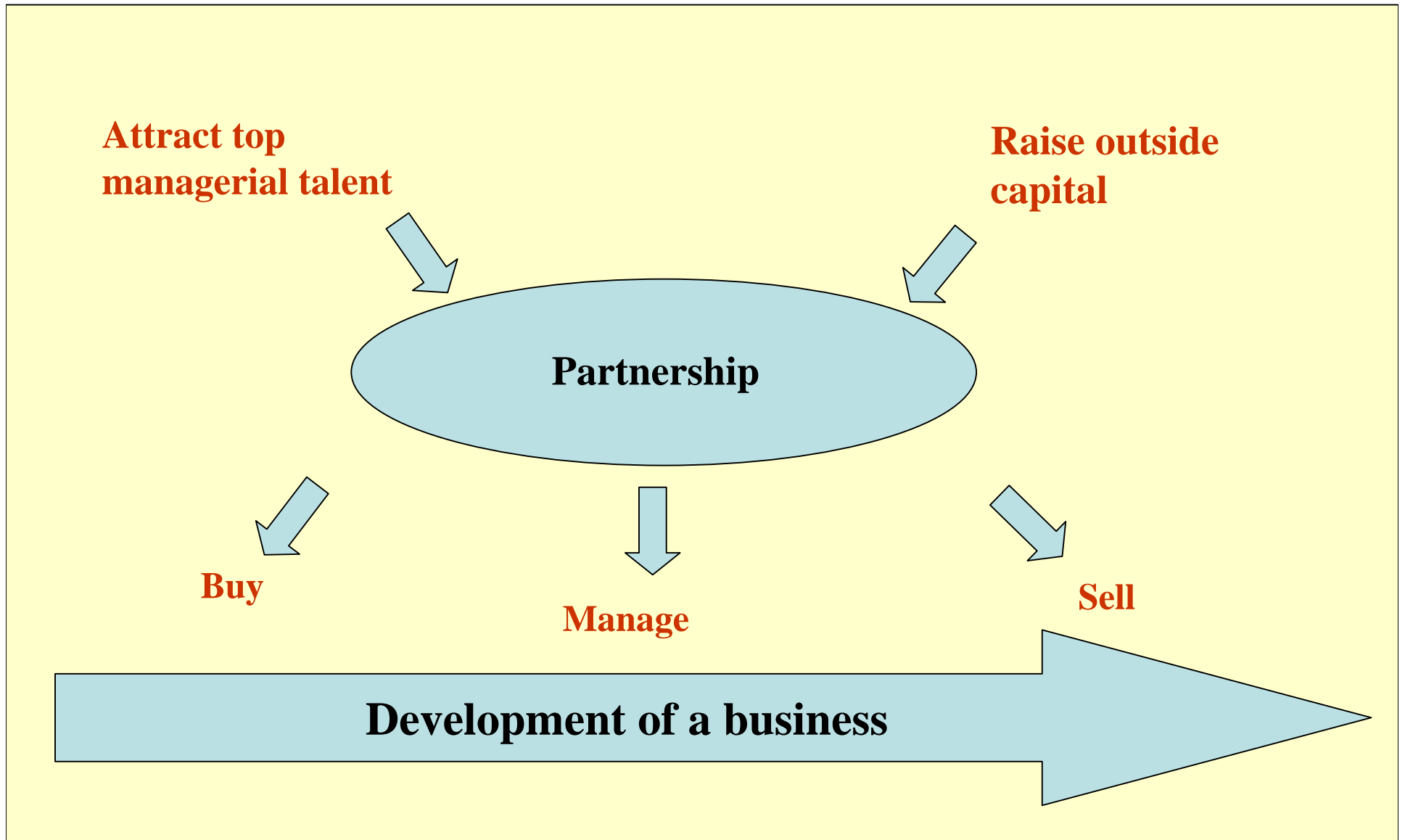
- Massive global savings
- Investment constraints in developed world
- Governance concerns in developing world

# Interest among UK pension funds

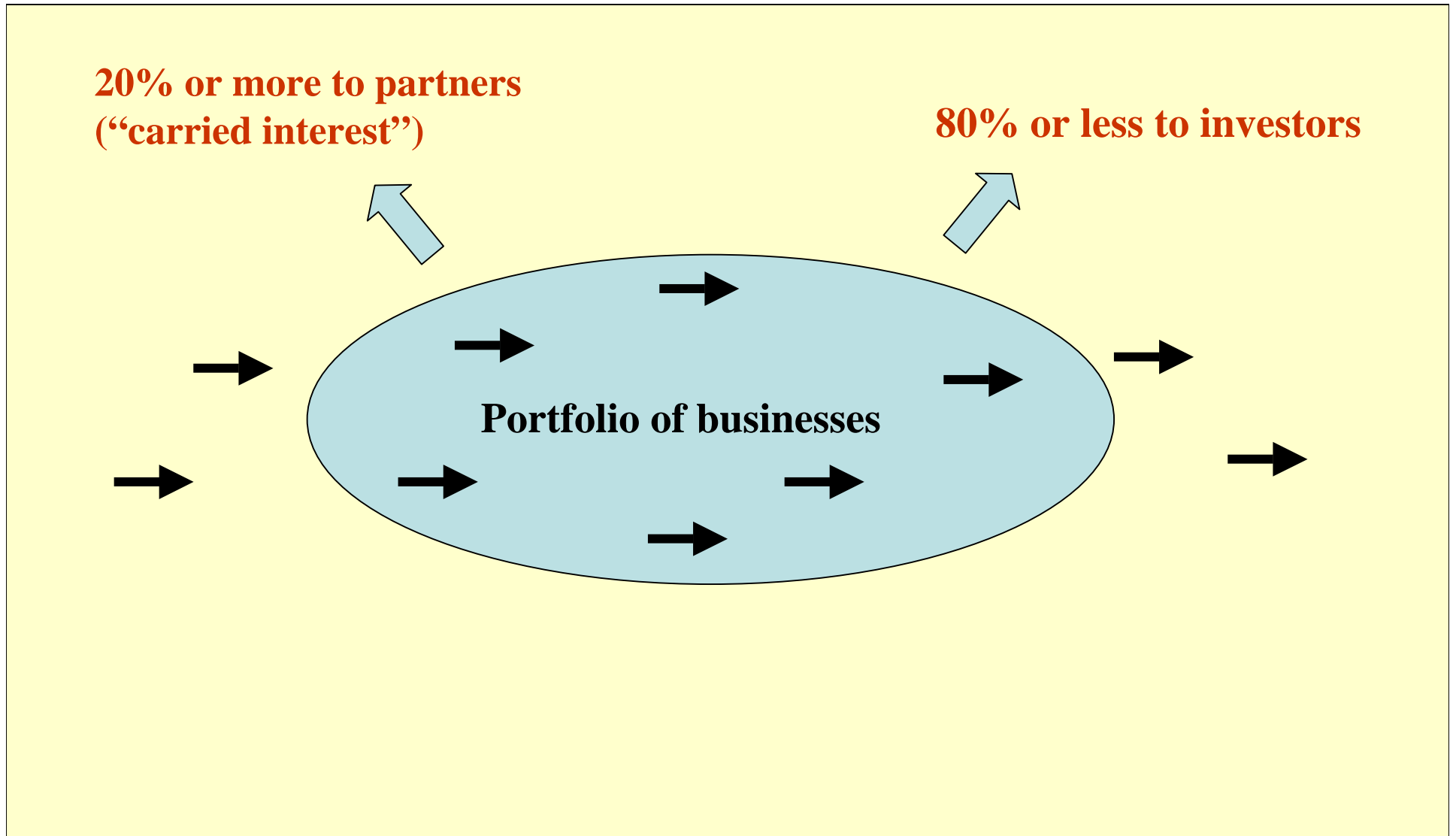
	Private equity	Hedge funds
Plans already invested	31 %	12 %
Average allocation among invested plans	2 %	5 %
Plans considering investment	26 %	40 %

*Source: JP Morgan Fleming Asset Management*

# Private equity business model



# Private equity business model



# Private equity risk and returns

## risk.....

- Portfolio valuations subjective and stale
- So past data understates true volatility

## .....and returns

- Late entrants pay higher prices
- So past data overstates future return expectations

# Private equity in the future

## advantages.....

- Attracting top management skills
- Harvesting across the business cycle
- Expect higher than average returns

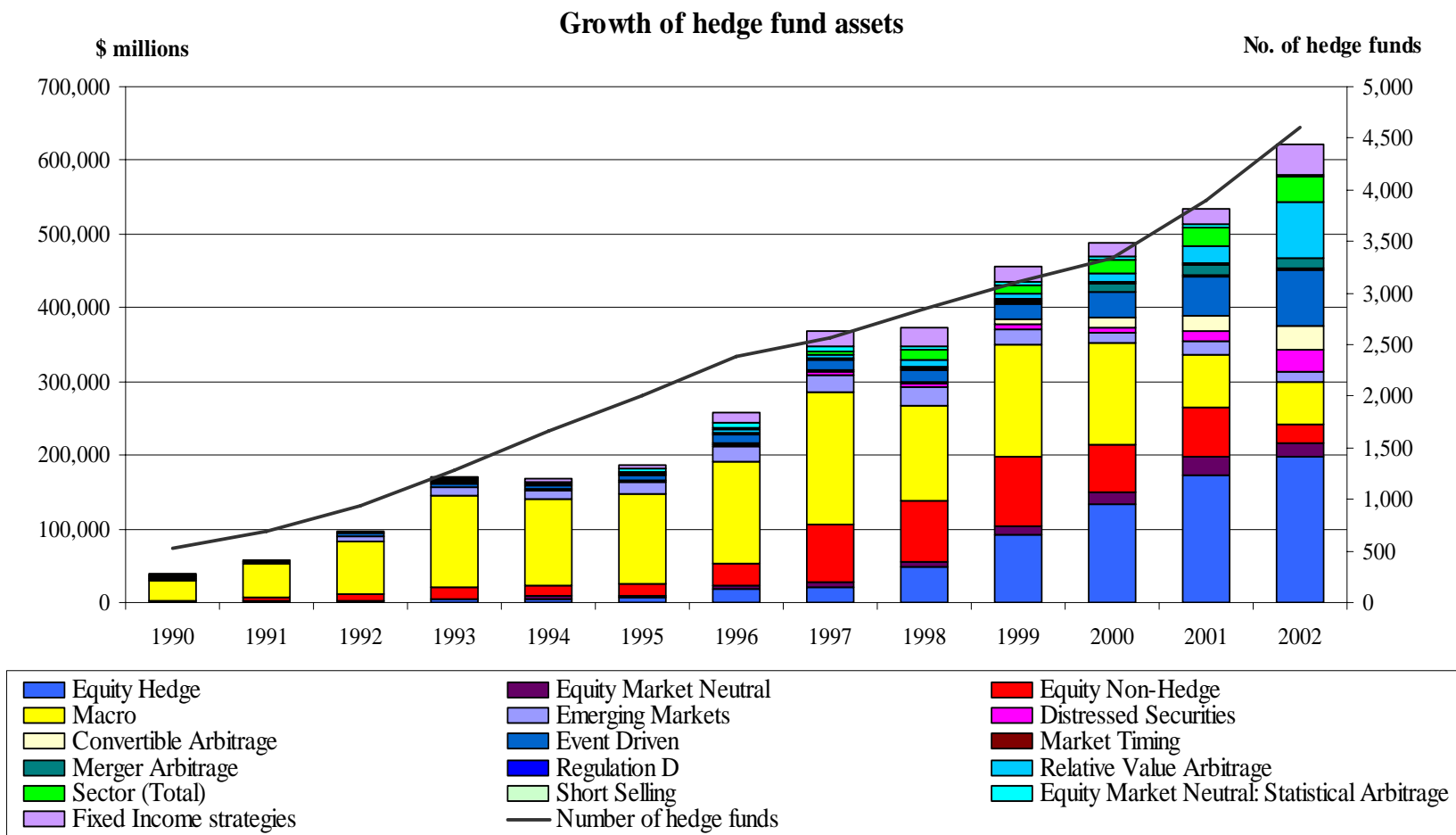
## .....and disadvantages

- Adds risk to portfolio
- High fees
- Very long lock-in period for investors

# What is a hedge fund?

- Private offshore fund
- Minimal supervision but cannot advertise
- Targets absolute returns
- Less volatility than equities
- Diverse tactics and strategies

# Growth of hedge fund industry

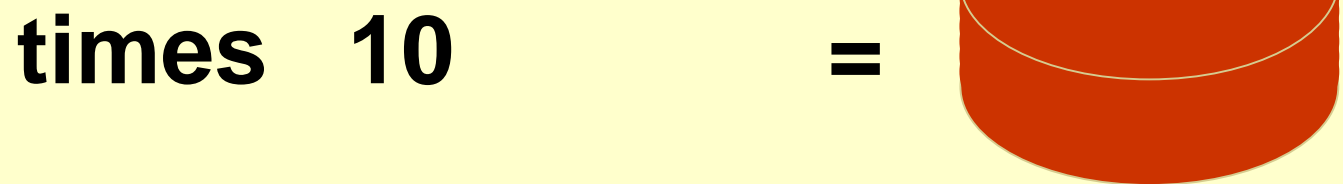


Source: Hedge Fund Research

# Hedge funds – how do they do it?

- Long / short equity
- Distressed securities
- Merger arbitrage
- Event driven
- etc.....

# Long / short equity strategy



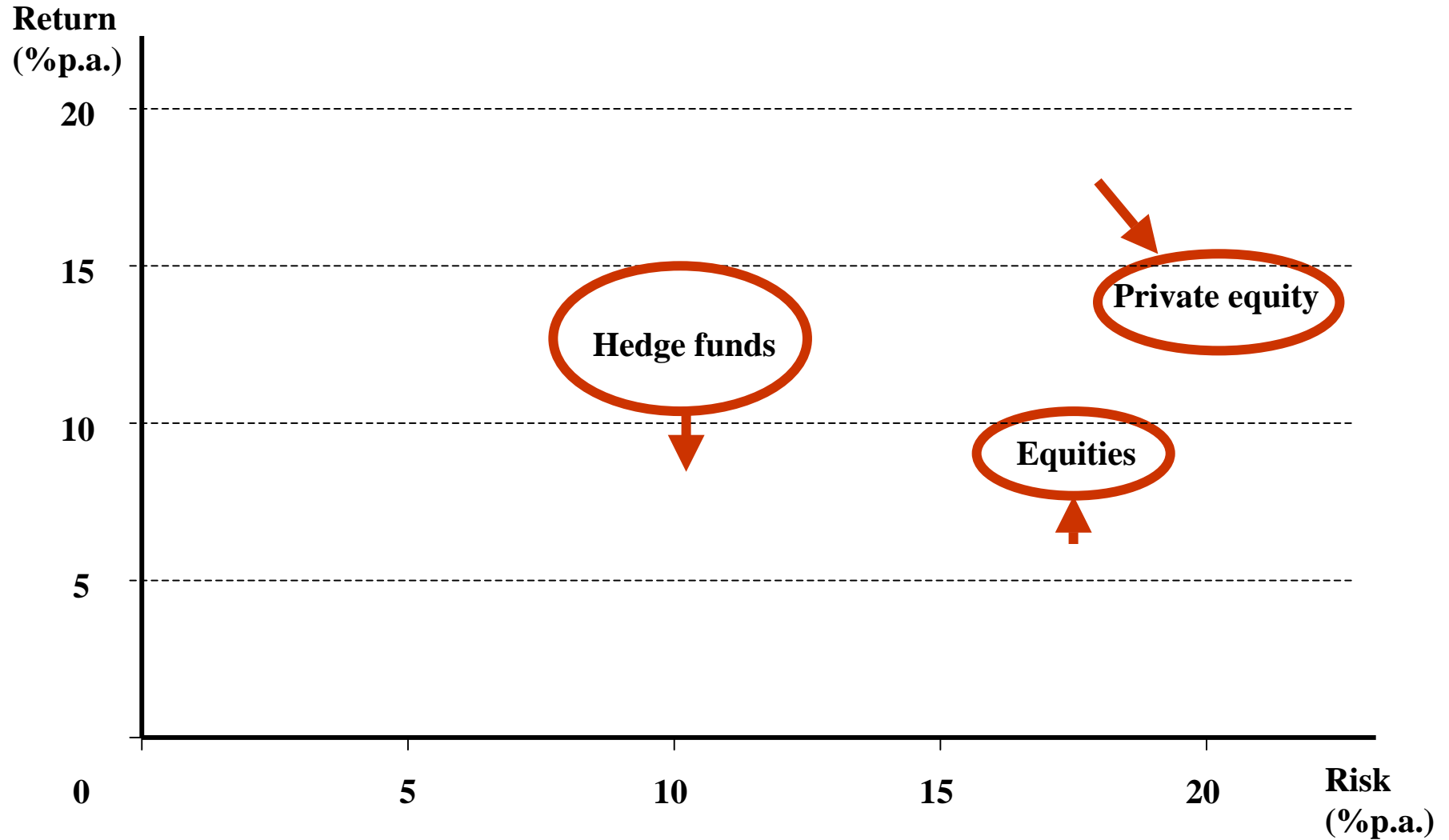
# Hedge fund issues

- Fees ~ 2% of fund + 20% of investment returns
- Secretive activity
- Fund of funds to diversify specific fund risk
- Fund of fund fees ~ 3% of fund + 30% of returns

# Hedge fund issues (2)

- High rewards attract top asset managers
- But many mediocre funds now
- Short life span
- Hedge fund returns edging closer to market returns
- Not worth the high fees?

# Future risk and return



# Summary

- More in bonds
- More in alternative investments (AI)
- Future AI returns not so exceptional
- Governance issues to be addressed