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Asset Allocation: When diversification fails

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What do Swiss pension funds do when risk budgets are stretched and diversification has failed? ***Barbara Ottawa*** *reports*

At a glance

- Swiss Pensionskassen have increased alternatives and illiquidity to replace bonds.
- Some have reached the limits in asset allocation and are looking at liabilities.
- Pensionskassen are showing a renewed interest in the mortgage business.

Last year the CHF9bn (€8.4bn) PKE Pensionskasse achieved a return of 7.3%, which is well over the market-average of just over 5%. “All asset classes did what they were supposed to do and performed,” says Ronald Schnurrenberger, managing director at the PKE Pensionskasse.

But he adds: “On the active side, in the asset allocation we have done everything we can and we have no more leeway left to optimise the portfolio for higher returns.”

Instead, the pension fund has commissioned its bi-annual asset liability study for this year. “After that we will probably adjust our liabilities and pension promises, not the asset allocation,” confirms Schnurrenberger. Results will be presented to the board in autumn.

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Ronald Schnurrenberger

In 2013 the Pensionskasse had been one of the first movers to lower the conversion rate under the then magic 6% threshold. “As per January 2014 we lowered the rate to 5.65% and back then this was among the lowest rates – today this is average and the lowest rates are at 4.8%.”

The liability side has been the focus of many Pensionskassen for some time now. “Practically all adjustments to technical parameters made by larger Pensionskassen over recent years can be explained by the low interest-rate environment,” says Willi Thurnherr, managing director at Aon Hewitt (URL=/searchResults.aspx?searchCode=2020) Switzerland. Some were made necessary by increasing longevity, but the low interest-rate environment is more important, he adds.

Stephan Wyss, partner at Prevanto, agrees: “There is no way around amendments to the liabilities – and many Pensionskassen have already done this unpleasant duty, while others only just started negotiating them”.

In Switzerland, the discount rate applied by companies under the IAS19 rules on employee benefits fell to its all-time low of 0.4% at the end of 2016.

Schnurrenberger says Swiss pension funds need higher interest rates: “What I would really like to see is for interest rates to suddenly jump up to 4% or 5%. Over the short term this would be very painful but it would only need a bit of nerve to get through this phase and then all Pensionskassen could recover.” He notes the increase in life expectancy is “something we know how to deal with”. It costs 50bps of return every year. But low interest rates have a much greater negative effect on the liabilities.

“Many Pensionskassen are discussing investments which they would not even have looked at two years ago”

Willi Thurnherr

“What Pensionskassen have realised is that diversification is not working as expected. Alternative investments do correlate, especially in times of crisis. Therefore, simply adding more asset classes is not the solution in the current environment. And, in fact, few Pensionskassen speak of further diversification for diversification sake. They are adding new asset classes in the hope for better returns,” explains Wyss.

Thurnherr confirms: “Many Pensionskassen are discussing investments which they would not even have looked at two years ago.”

But Wyss is not sure whether this is always a good thing. “As the hunger for return increases, Pensionskassen are going back into illiquid instruments they last tried prior to the 2008 financial crisis – but the problem is that these instruments are not suitable for all portfolios. Some Pensionskassen only consider certain instruments because they see others do it as well.” He explains that investment in illiquid assets is easier for Pensionskassen with a strong plan sponsor, like a municipality or an authority.

Wyss says: “Investment principles are slowly eroding. Pensionskassen remain cautious but investments that would have been considered an absolute no-go a few years ago are being looked at today, and tomorrow the investment is made.”

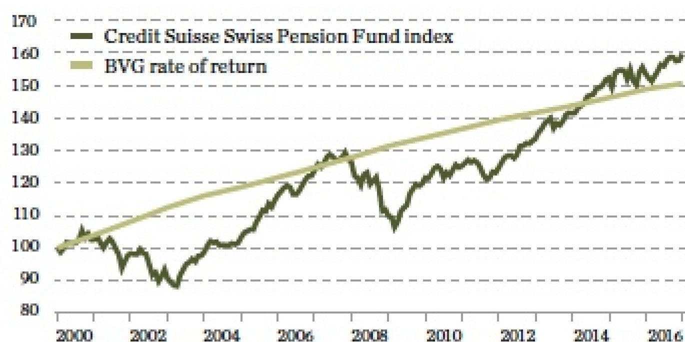
The instruments being considered range from insurance-linked investment to infrastructure, commodities, different kinds of asset-backed securities (such as collateralised loan obligations), private equity, private debt or hedge funds.

“A lot of products are being reviewed but very often it is old wine in new bottles,” says Wyss. “We have already seen such phases before when Pensionskassen got a lot of returns from their equity investments and invested a lot in hedge funds. But they were disappointed and they sometimes withdrew completely from hedge funds.”

Schnurrenberger is also sceptical about some alternative investments. “Hedge funds have not achieved what everyone expected. So we will not simply flee into alternatives,” he says.

Furthermore, too many alternative investments would lead to a higher total expense ratio (TER). “Our members are cost conscious,” says Schnurrenberger.

1. Credit Suisse Swiss Pension Fund index versus BVG mandatory minimum rate of return



Source: Credit Suisse Pension Fund index 2016

Wyss says Pensionskassen have become much more aware of costs since interest rates became negative and the supervisor introduced the requirement to report a TER quota for the portfolio. “When 15% of the portfolio produces 80% of the costs this might be difficult to explain.”

He is even more surprised by the products themselves. “I do not understand how alternative asset managers can keep the costs as high as they do in the current low-interest rate environment and seeing how much returns from their products have come down. On the equity side many Pensionskassen have defined a limit according to their risk budget and this cannot be easily increased,” explains Wyss.

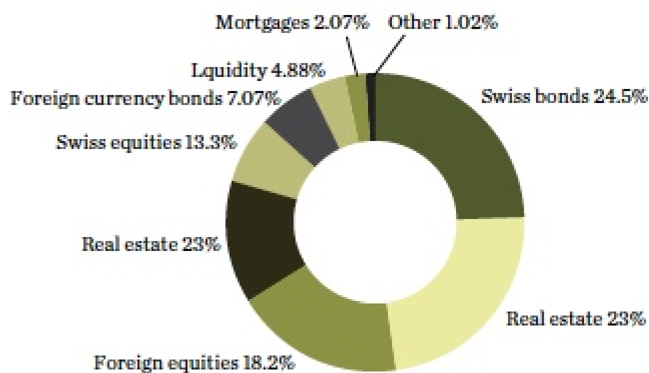
The PKE pension fund has 40% of its portfolio in mostly foreign equities. “We are one of the few Pensionskassen without a separate category for domestic equities because we have too few,” says Schnurrenberger. Similarly, in the bond segment, the pension fund now has a higher share of foreign than domestic bonds.

“But for Swiss investors foreign investments are expensive because of the FX-hedge,” explains Schnurrenberger. “We are hedging 75% of the four main global currencies because we see currencies as speculation – and we do not want to speculate.”

At Complementa Investment-Controlling, CEO Heinz Rothacher, confirms sinking FX exposure in portfolios. “This is down to Pensionskassen hedging more foreign currencies against the Swiss franc.”

Schnurrenberger highlights another difficulty with volatile equity investments. “In our experience doing less is better for a long-term investor as events seldom unfold the way they were expected to. Being too active an investor would be speculation. So actually a Pensionskasse has to live with day-to-day volatility, which can exceed its annual return. This is very difficult to explain to members and the board. Sometimes it is also very hard to really sit out a real market downturn.”

Another trend Wyss sees is an increase in cash holdings. "Some Pensionskassen have begun substituting bonds for cash not to increase returns but to lower the interest-rate risk on the active side."



All experts agree that bond exposure is coming down. Thurnherr notes a diversification into foreign bonds, including FX hedging, and a lowering of the credit-rating average in the investments.

Rothacher adds: "Instead, Pensionskassen are making full use of the equity and real estate quotas."

Wyss says: "After 2008 some pension funds categorically rejected all illiquid investments and today they go back into real estate. But it is a fact that real estate is a good reflection of the needs of a Pensionskasse."

However, Thurnherr points out: "There is a very narrow bottleneck when it comes to domestic real estate, as most funds are closed or investors have to pay very high premiums to get in." Therefore, many Pensionskassen are looking into foreign real estate and larger providers have gone into construction themselves.

And Wyss explains: "Diversification into foreign properties happens via indirect vehicles like REITs."

Schurrenberger points out: "Of course, real estate offers higher returns than domestic bonds, but if you really want higher returns everything is much too expensive."

The PKE has 80% residential properties in its portfolios. "The more time passes the more it shows that a good portfolio is worth a lot and a portfolio that is simply patched together from various purchases is a problem." The PKE is currently mainly optimising its existing portfolios via renovations and developments rather than buying new properties.

But there is also a Swiss 'special' when it comes to property-related investments "Many Pensionskassen are going back into mortgages, a business most exited five years ago. Back then they stopped offering mortgages because interest from this business was not very attractive, the risk had gone up and administration was too costly as due diligence is necessary both on the property as well as the debtor," Thurnherr explains.

He explains the particular features of the Swiss mortgage business which make it attractive for long-term investors: for tax reasons mortgages in Switzerland are rarely paid off early.

Schnurrenberger confirms that "we are seeing others just starting in the segment of mortgages". The PKE itself has never stopped issuing mortgages, but he says: "If you are starting in this segment from scratch it needs a lot of investment and you need to build up expertise. Overall, the mortgage business is not the salvation either, because it can only be a substitute for parts of the bond portfolio."