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RISK Management Conference

AUGUST 10 – 12, 2016

SHAKE IT UP: PENSIONS MAKE A SHIFT IN VOLATILE TIMES

Featuring:

DR. MEGHAN O'SULLIVAN
Understanding energy prices

ALTERNATIVE RISK PREMIA
Turning water into wine

ALL ABOUT ANNUITIZATION
Panel discussion

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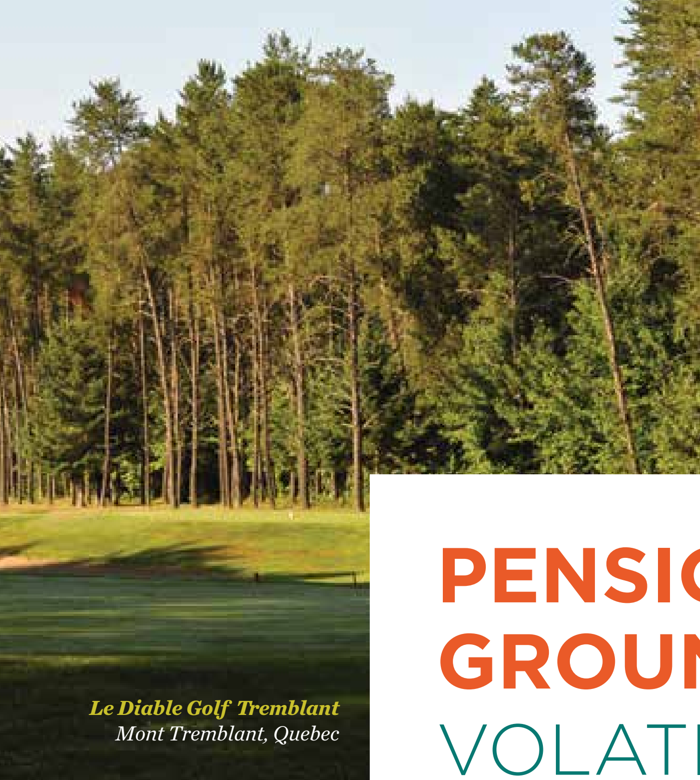

Le Diable Golf Tremblant
Mont Tremblant, Quebec

PENSIONS ON SHAKY GROUND: DEALING WITH VOLATILITY

Intense volatility – on just about every front – has been a challenge for Canadian-defined benefit pension plan sponsors. When looking at equity markets, energy and oil prices, currency and the global economy, instability has been the name of the game across the board.

At the 2016 Risk Management Conference, we explored the drivers of volatility across borders and markets, delving into the issues it presents for DB pension plans. And, importantly, we discussed ways to mitigate volatility, recognizing that, at the end of the day, pension funds do need to generate returns.

Looking at the evolution of global energy markets and Canada's role in the landscape, keynote speaker Meghan O'Sullivan walked us through the dynamics of energy pricing and the fundamental shift underway in the space today, as we move from supply-driven to demand-driven prices.

One of the big conversations that was had at the conference involved factors – presenters looked at different ways of slicing and dicing index returns, integrating multiple factors and understanding how a layer of active decision-making can enhance returns and dial down the risk.

We also looked at other ways plan sponsors are looking at to push risk off the table, from risk-sharing arrangements to the burgeoning world of annuitization – a growing part of the toolkit as corporate pension funds continue along the de-risking path.

We hope you enjoy the coverage and find it helpful as you navigate your way through today's complex and volatile investment world.

BY SCOT BLYTHE

WHAT'S DRIVING ENERGY PRICES? GEOPOLITICS, ENERGY AND THE LAWS OF SUPPLY AND DEMAND

HARVARD KENNEDY SCHOOL, HARVARD UNIVERSITY

Meghan O'Sullivan

JEANE KIRKPATRICK PROFESSOR OF THE PRACTICE OF INTERNATIONAL AFFAIRS AND DIRECTOR OF THE GEOPOLITICS OF ENERGY PROJECT

Keynote speaker Meghan O'Sullivan, the Jeane Kirkpatrick Professor of the Practice of International Affairs and director of the Geopolitics of Energy Project, Harvard Kennedy School, Harvard University, spoke about the geopolitics of oil. We sat down with Meghan and asked a few questions about the impact of Middle Eastern politics, renewables, and shifting Chinese demand on oil prices, and energy in general.

WHAT'S DRIVING ENERGY PRICES RIGHT NOW?

As is always the case, many things are affecting the price of oil right now. Supply and demand determine price, so anything that changes those parameters impacts price. I'd highlight a couple things of particular importance. First is that this big drop in price we have seen is the result of a supply surge – much more than a diminution of demand. In fact, demand for oil has actually picked up since 2014, spurred on in large part by the lower prices. The supply surge is attributable both to the new shale oil, or tight oil, that has rushed to markets in the last few years, and to the changed strategy by Saudi Arabia and other OPEC producers to pursue market share rather than protect price.

Both the politics of OPEC and the technology that made these new advances in shale possible are likely to put downward pressure on price for the foreseeable future. But – and here is my second point – there is much speculation about a price spike right now.

Some anticipate a spike could occur as a result of the huge cuts in investment over the last 18 months that will undoubtedly affect production in the months and years ahead. Whether this price spike materializes really depends on how quickly shale production responds to higher prices, how robust global demand is, and whether other countries (i.e., Saudi Arabia) build any new capacity in the years ahead.

HOW DO SAUDI POLICIES – GEOPOLITICS – FIT INTO THE STRUCTURE OF ENERGY PRICES?

Many people were quick to conclude that, because the drop in oil prices was so damaging to Saudi Arabia's adversaries – particularly Iran – animosity must be the primary motivator of Saudi Arabia's changed oil policy. I tend to disagree and think the shift in strategy to go to an approach prioritizing market share had a lot more to do with structural changes in the oil market – and what Saudi Arabia assessed they would mean for it.

The main issue is that the advent of shale oil – or tight oil – has introduced an entirely new business model into the market.

Before shale, non-OPEC supply took a long time to respond to price. When the price of oil went up, producers needed to decide whether to invest huge amounts of money in investments that would only bear fruit over years. Tight oil works very differently; it requires many small investments, which create new production very quickly. It also requires continuous investment to keep production high.

Given these new dynamics, I think the Saudis assessed that, if they cut their production to raise the price of oil, the benefits might only be short-lived because this new, tight oil resource could swoop in and very quickly take the market share that Saudi Arabia relinquished.

HOW MUCH OF AN INROAD HAVE ALTERNATIVE SOURCES OF ENERGY MADE?

Alternative energy, particularly renewable energy, has made an appreciable impact on the world's energy mix. In just the last few years, the prospects for these energy sources have improved significantly, on account of costs coming down. Renewable energy makes up perhaps one-seventh of primary energy supply in the world; but, if we just look at the power sectors, the position of renewables is much stronger.

It is here in the power sector that renewables will continue to make the biggest impact in the coming years.

One thing to keep in mind when talking about the impact of renewables is that, as of right now, renewables can be a great substitute for natural gas or for coal (or nuclear for that matter), but they are really not yet a substitute for oil. This is because of the lock that oil has on transportation – close to 95 per cent of the world's transportation runs on some oil-based fuel.

Until this changes – through a massive increase in electric car deployment or something else – renewables can grow like gangbusters and not really affect oil's dominance.

ARE WE SEEING A STRUCTURAL SHIFT IN DEMAND?

We're definitely moving into a period where there is lower energy demand *growth* and likely lower oil demand growth. Over much of the 2000s, the annual growth in energy demand was very high, in large part due to China's incredible overall growth and its energy-intensive nature. Now we're moving into a period where the demand for energy and for oil is still positive, but is growing less robustly than it had in the previous period.

Many people were quick to conclude that, because the drop in oil prices was so damaging to Saudi Arabia's adversaries – particularly Iran – animosity must be the primary motivator of Saudi Arabia's changed oil policy. I tend to disagree.

If oil sands continue to be more expensive to produce than, say, American tight oil – the cost of which has already declined even in the last 18 months – the future of oil sands will probably not be too bright.

Many of the drivers of energy demand growth are still positive – urbanization, population growth, economic growth – but they're just not growing quite as rapidly as they were, say, 10 years ago.

Again, China is a big part of this story. Its slowdown – and its efforts to shift to a less energy-intensive economy overall – will be critical in shaping overall global energy demand growth.

WHAT ARE THE PROSPECTS FOR CANADA'S OIL SANDS, GIVEN HIGH COST STRUCTURES?

I can imagine that the calculations for oil sands producers now are quite difficult. The two most important variables, of course, are technology and price. Will producers be able to find new ways of bringing down the cost of producing oil sands? If so, then many projects might be viable in the new energy environment.

But if oil sands continue to be more expensive to produce than, say, American tight oil – the cost of which has already declined even in the last 18 months – the future of oil sands will probably not be too bright.

Again, technology and efficiency are the key. We saw tremendous cost-cutting due to both in the production of American tight oil. No doubt, oil sands producers will need to work equal magic if they are to have a future over the long term.

BY SCOT BLYTHE

ASK US ANYTHING ABOUT: BREXIT

PANEL DISCUSSION TACKLES THE FALLOUT OF BRITAIN'S BIG VOTE

The market reaction to the surprise results of the Brexit vote was sharp and swift – but also very short for asset managers, at least so far. Part of the reason could be that the vote itself was simply the first move in what could be an extended process, according to participants in a panel discussion on the potential fallout from the Brexit vote.

The real challenges will come to light following the decision by the U.K. government to invoke Article 50, which calls for two years of negotiation, after which their marriage with the E.U. will come to an end. Then the rubber hits the road as the U.K. government tries to negotiate upwards of 450 separate trade agreements with extremely limited resources.

For portfolio managers seeking bargains, the market reaction was unforgiving. "There was a very quick downgrade of U.K. GDP growth expectations," notes Nelson Yu, portfolio manager and head of equity quantitative research at AB. "Actually, what's been frustrating to the portfolio managers is the lack of opportunities that have surfaced from this, because the markets seem to have priced very efficiently but then very quickly bounced back up."

The impact, so far, seems to have been limited to the U.K., with the pound plunging 17 per cent to a 20-year low. "Our expectation is that we might flirt with recession," explains Johanna Kyrklund, head of multi-asset investments at Schroders. "Consumer spending is holding up, but there will be a very clear GDP impact on the U.K. The evidence at the moment in the City is that things could quite literally come to a standstill because people don't know what environment they're operating in any more, since this is unprecedented."

"That said, the real impact that lies in waiting is the threat that Brexit poses to Europe's fragile banking system. Italian banks are already 'danger close,' and this uncertainty represents a more dramatic risk," says Lloyd Komori, senior vice-president, risk management at OMERS.

"Brexit is not going to help European banks," argues Sebastien Page, co-head of T. Rowe Price's asset allocation group. "They're already struggling; their valuations are extremely cheap, but they might continue to be cheap. Damaged banks might reduce lending, which could lead to lower consumer spending. Europe may not fall into outright recession, but it's unlikely that we'll see a positive growth shock out of European and developed market equities."

For Terri Troy, CEO/CIO of the Halifax Regional Municipality Pension Plan, "the big lesson with Brexit was 'don't rely solely on market sentiment,' because clearly it was wrong. It just reinforces the need for a robust risk management system."

And that now includes gap risks, says Page, like political risks or rising anti-globalization sentiment, or the recrudescence of nationalism – things that were faraway concerns a few years ago.

BY SCOT BLYTHE

TURNING WATER INTO WINE: UNDERSTANDING WHAT GOES INTO ALTERNATIVE RISK PREMIA

In an environment where return prospects seem constrained, it is natural for investors to look for other sources of return. And there may be many.

"In equities alone, there has been one new equity risk factor discovered every month for the past 10 years, and this has resulted in what John Cochrane has called a factor zoo," says Johanna Kyrklund, head of multi-asset investments at Schroders.

While there may be more animals to put in the zoo, "there's no point in us trying to search for these factors ourselves," Kyrklund says. "Really, our job is to sift through all these factors and identify first those factors that have a return associated with them. That is because there's a difference between a factor that explains risk and a factor that is actually associated with a source of return."

More than that, most academic papers look at risk premia in isolation. "We need to identify exposures that actually diversify the portfolio. If all we're doing is doubling up the allocation, we haven't made our lives any better," she adds.

Many of the factors already exist in the portfolio, suggests Kyrklund. The value premium, credit risk, carry: "these have all been the core ingredients in active management."

SCHRODERS

Johanna Kyrklund

HEAD OF MULTI-ASSET INVESTMENTS

Our job is to sift through all these factors and identify first those factors that have a return associated with them. That is because there's a difference between a factor that explains risk and a factor that is actually associated with a source of return.

Of the alternative premia, she says, carry is the most interesting. Despite its low correlation, however, "the reality is that the tail risk is quite significant, so you might be diversifying by payoff, but ultimately you can get very correlated with your traditional risk premia."

On the other hand, "we like value; we like it from an intellectual standpoint as well ... [but] it's somewhat capricious. What I mean by that is that it can be out of favour for five years, as we found recently."

As attractive as alternative risk premia may be on paper, "you need to be careful about magnifying it within the portfolio in a way that is not controlled and careful," she warns. That also applies to the use of leverage. Theoretically, one could justify a 90 per cent exposure to alternatives, but that would imply gross leverage of around 800 per cent.

Beyond that, she notes, "one of the things we found when we did the naive combination of alternative risk premia is that, although the risk-adjusted return improved significantly, the skew and kurtosis of the distributions deteriorated because you're basically introducing more left tail risk."

Risk premia should be intellectually rigorous, she says, but warns of data mining. "We're not there to be theoretically right; we're there to make money for the client."

BY CAROLINE CAKEBREAD

HAS LOW VOLATILITY BECOME HIGH RISK?

STOCK-SPECIFIC RESEARCH MIGHT HELP ANSWER THE QUESTION

The shift to low volatility equity investing makes sense especially among pension investors looking to avoid drawdowns during up and down markets. But as institutional money flows into these strategies, one new question looms – is all this attention making low volatility strategies more risky? That's the question that Tim Choe, quantitative analyst with Fidelity Investments, has sought to answer through his own research.

> *Surprisingly, the bigger driver of future risk outperformance for low volatility equity strategies is forward-looking stock-specific risk information in comparison to common factors.*

He explains that, right now, low volatility equities are richly valued and, hence, expensive. As Choe notes, when low volatility stocks are cheap, they tend to outperform the market: "In the U.S., when low volatility stocks are in the cheapest quintile in history, they provide 0.51 per cent more return per month versus cap-weighted equities" he says.

Another driver of under- or outperformance is interest rates. As interest rates went down, low volatility equities did better. So given the current low interest rate environment and potential for future hikes in interest rates, low volatility would seem to be poised to underperform.

However, Choe points out that if one were to use valuation or interest rates to time between low volatility equities and cap-weighted equities, the risk-adjusted returns don't improve at all.

At the same time, interest rates are notoriously hard to predict, so why bother trying to time low volatility at all? Rather, asks Choe, "Why not just time stocks and bonds with a 40 per cent increase in risk-adjusted returns, rather than low volatility, if one knew exactly where interest rates are going?"

A better approach could be fundamental analysis on a stock-by-stock basis – such insights on stock-specific risks can help investors determine which stocks will do better in different market conditions.

While none of these strategies is ideal – they are all predicated on being able to know future risks and where markets will go – "both returns and risk-adjusted returns improve for low volatility equity strategies with knowing future risk," Choe explains. "Surprisingly, the bigger driver of future risk outperformance for low volatility equity strategies is forward-looking stock-specific risk information in comparison to common factors." However, while stock specific risks matter more, they can be difficult to capture quantitatively and require in-depth fundamental research on a per-stock basis.

Turns out, factor risk is harder to manage than we thought – and perhaps it takes a bit more than a passive approach.

FIDELITY INVESTMENTS

Tim Choe

QUANTITATIVE ANALYST

BY CAROLINE CAKEBREAD

A MATTER OF STYLE: FACTORS, ECONOMIC CYCLES AND THINKING OUTSIDE THE BOX

AB

Nelson Yu

PORTFOLIO MANAGER AND HEAD OF QUANTITATIVE RESEARCH – EQUITIES

Since 2008, equity volatility has prompted plan sponsors to consider de-risking strategies in an effort to get away from the roller-coaster movements of markets. But where does that volatility come from – and is there a way to understand how equities move in relation to different parts of the economic cycle? Nelson Yu, portfolio manager and head of quantitative research, equities, at AB, believes it's possible – but it's a matter of style.

Yu considers the basic style boxes investors tend to think about when looking at returns: large-, mid- and small-cap, as well as value, core value and growth. While these factors are well known among investors, less is known about how each performs in a shifting economy. For example, notes Yu, during times of economic or geopolitical volatility, which factors would under- or outperform?

Through his own analysis, Yu has been able to break down the performance of specific factors based on economic cycles – rising and falling economic growth and interest rates. "As economic growth starts to take hold," Yu says, "the economy shifts into an expansionary period and rates start rising." Further into the cycle, rising interest rates can moderate economic growth. As we move into economic contraction, interest rates fall again.

UNDERSTANDING THE CYCLE

And so the cycle continues – with a direct impact on factors. By using the Purchasing Managers Index, a key indicator of the economic health of the manufacturing sector, Yu shows how factors perform during different cycles – and maps them according to period.

During times of recovery, Yu explains, cyclical value and small cap did the best, while the low risk factor did best during periods of economic contraction. Growth did best during periods of expansion while growth and quality both did well during periods of moderation. Economic slowdowns send investors running to safety as they seek companies with higher and more stable levels of probability, Yu says.

The question is, how can investors apply this to portfolio construction? Yu applies his model to MSCI factor indices to show which ones are more or less correlated during different cycles. "The MSCI Value factor has the most correlation with the recovery period of the economic cycle," he explains. The MSCI USA Growth Index is negatively correlated to cyclical value. It does poorly in the recovery, but starts doing well as economic growth takes hold in expansion and moderation, just as the Value Index works less well.

In the end, it's all about the cycles – understanding which factors do what during each point is key to outperformance and, ultimately, equities allocations.

Through his own analysis, Yu has been able to break down the performance of specific factors based on economic cycles – rising and falling economic growth and interest rates.

BY CAROLINE CAKEBREAD

TAKING COVER: COVERED CALLS ENHANCE A MANAGED VOLATILITY STRATEGY

What is keeping Canadian plan sponsors up at night? The same issue that troubles most investors globally: market volatility. And for pension funds with little capacity to absorb drawdowns, it's arguably an even bigger issue than it is for the typical investor. Sebastien Page, co-head of T. Rowe Price's asset allocation group, argues that too much focus has been placed on trying to forecast returns in an effort to allay investor fears. Instead, he says, risk forecasting is "a much more effective way to understand portfolio management."

One frequently asked question: Has volatility increased in the equity markets? Page argues that it has, using the U.S. market as an example. "Since the 1940s, the number of days when the S&P 500 Index moved up or down by three standard deviations or more has increased from an average three days per year to nine days per year or more," he notes. The result: fatter tails on the distribution of daily returns.

T. ROWE PRICE

Sebastien Page

CO-HEAD OF THE ASSET ALLOCATION GROUP

Since the 1940s, the number of days when the S&P 500 Index moved up or down by three standard deviations or more has increased from an average three days per year to nine days per year or more.

Page attributes this increase in big market swings to central bank intervention, which he believes has made markets more fragile. Add to that the increased use of derivatives, increasingly interconnected markets and the growth of high frequency trading, and you have a possible explanation for the persistent high volatility that has dogged investors over the last few years.

A standard 60/40 bond-equity portfolio will not cushion this volatility, Page contends. Investors need to look elsewhere. One possibility is to adopt a managed volatility strategy, which allows sponsors to de-risk their portfolios when market volatility goes up. "You might go as low as a 20 per cent equity beta in the portfolio or as high as 75 per cent, depending on your volatility target," Page explains.

Implemented as an overlay on an equity portfolio, a managed volatility strategy can lead to a much smoother ride, he says.

USING COVERED CALLS

Managing volatility is a valuable objective, but plan sponsors still need returns. Covered call writing can help enhance returns in the context of a managed volatility overlay, Page says. Combining a managed volatility overlay with a covered call writing strategy can be effective for plan sponsors because returns on the two strategies historically have been negatively correlated, he concludes. Thus, in his view, a combined approach can provide uncorrelated returns and risk management benefits when plan sponsors need them most.

A managed volatility strategy allows sponsors to de-risk their portfolios when market volatility goes up.

BY CAROLINE CAKEBREAD

FIXED INCOME 2.0: UNDERSTANDING RISK IN A CHANGING BOND PORTFOLIO

Fixed income investors face a major conundrum – and plan sponsors most of all. "We're in a world where rates are low but they might rise any time," says Tom Coleman, senior investment specialist with Standard Life Investments. But there are many unknowns and risks for pension investors in this low yielding environment.

Right now, pitfalls abound – drawdown risk following rising rates, default losses in the credit space, and high correlations between fixed income and equity markets. Because, says Coleman, "when the credit cycle ultimately does turn, investors will need to deal with those default losses."

Fixed income has evolved to a point where it no longer plays the same old role in a pension portfolio, where investment grade and government bonds dominate and deliver duration matching, income and safety. Today, plan sponsors are taking a more tactical approach – but with higher returns comes higher volatility.

Today more than ever before, says Coleman, "the fixed-income world presents us with a wide range of risk-return outcomes." While returns can be challenging, investors can think differently about the risk side of that equation.

By looking at risk, rather than asset allocation, a portfolio can look completely different. Using the example of a basic portfolio that is half credit and half cash, Coleman explains that, while this portfolio looks undiversified, it could take on many different risks depending on the nature of the positions – "each represents different types of risks: FX, duration, positions across countries, credit, yield curve, cross-market or relative value positions."

Dig under the surface and there's more to risk than simply the basic assets on the surface. "This portfolio is a lot more complex than you would have seen initially, with more diversification of ideas from across a spectrum of fixed-income opportunities. It creates a much more balanced picture."

To get at the real risk of the portfolio, however, investors need to take a three-stage approach to risk management – risk modeling ex ante, scenario analysis and behaviour of a portfolio based on identified risks.

"Understanding what level of volatility happened yesterday can show you what could come to pass in the future," Coleman says – and it needs to be considered on a continuous basis. "Use what's going on the market to review your positions in a portfolio – check if it's consistent with what you're expecting and whether it's different enough to contemplate a change in the position." That way, investors can be best prepared for the future.

Today more than ever before, says Coleman, "the fixed-income world presents us with a wide range of risk-return outcomes."

STANDARD LIFE INVESTMENTS

Tom Coleman

SENIOR INVESTMENT SPECIALIST

BY SCOT BLYTHE

CRASH RISK 101: HOW TO SPOT HIDDEN VULNERABILITIES IN THE MARKET

Events have a funny way of driving home what may first seem to be academic observations. Case in point: just a few days after Seth Weingram, senior vice-president and strategist at Acadian Asset Management, made a presentation on crash risk at last year's Risk Management conference, the market tumbled – 11 per cent.

That sell-off, Weingram says, raised questions as to whether some of the very portfolio management techniques adopted to mitigate risk might have actually stirred up the market – similar to the 1987 crash. "People were particularly surprised because there wasn't a clear cause for this type of reaction," Weingram says. "Certain types of strategies may have been creating mechanical, programmatic flows that actually exacerbated the sell-off."

While portfolios that dynamically adjust equity exposure depending on market volatility have become popular, their precise market impact is open to debate, says Weingram.

On the portfolio side, the danger is that such programs accomplish the opposite of what was intended. By de-levering equity exposure, they may sell into a falling market, with volatility triggering more volatility. Conversely, restoring target equity exposure may come when the markets have already recovered. As well, approaches like these may be vulnerable to "valuation-insensitive drift in portfolio weightings" because "the risk allocation model may gradually increase your investment in an asset class where the perceived risk is falling, whether or not the valuations still make sense."

UNMASKING OTHER RISKS

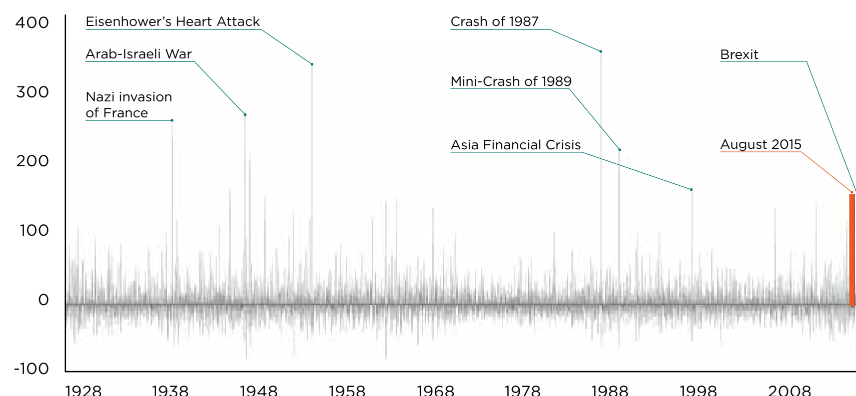
In this year's presentation, Weingram also highlighted two other subtle forms of risk that may be lurking in portfolios as a result of investor efforts to reduce market exposure and squeeze out higher returns in a low rate environment.

First, with respect to alternatives, academic work by Jakub Jurek and Erik Stafford suggests that, "in aggregate, a material fraction of hedge fund returns may reflect a premium for bearing non-linear downside risk, rather than true alpha," says Weingram.

Second, with respect to private equity, recent research from Stafford highlights the possibility that smoothing of reported returns is masking the economic risk of the asset class. After accounting for such effects, "the notion that private equity is generating superior performance relative to public equities due to some abnormally rich liquidity premium or special financing may not hold water."

These cautions aren't to say that hedge funds or private equity can't add value to a portfolio, he explains. "But just be careful that you're not simply trading off apparent market exposure for forms that are more obscure and expensive."

WEEK-ON-WEEK % CHANGE IN 1-MONTH S&P 500 REALIZED VOLATILITY



For Illustrative purposes only. Figure charts percentage change in trailing realized volatility vs. 5 trading days prior as of each trading day from 7-Feb-28 through 24-Aug-16. Realized volatility calculated using 21 trading day windows of log returns and a 252-day annulization factor. Investors have the opportunity for losses as well as profits. Past performance is no guarantee of future results.
Source: Acadian estimates and calculations based on index levels from Bloomberg.

ACADIAN ASSET MANAGEMENT

Seth Weingram

SENIOR VICE-PRESIDENT, STRATEGIST

BY SCOT BLYTHE

ARE YOU IGNORING CURRENCY RISK?

WHY HEDGING ISN'T AN "EITHER-OR" DECISION

Pension funds are often sitting on exposures that, if managed in a thoughtful manner, could add to portfolio returns. Currency is one such exposure, says Valerie Dion, senior consultant at Russell Investments.

"Every marginal improvement you can make to the portfolio does matter," she explains, while specifying three principles: "don't take risks you don't get compensated for, look for return-seeking strategies, [get] better implementation."

Dynamically managing currency could have contributed 60 basis points to annual returns from 1999 to 2016, she notes, but that requires a thoughtful analysis and decision-making. The data is episodic, and the research on static optimal hedge ratio is inconclusive. "If you want to give me a hedge ratio and give me a little bit of time, I'm sure I can find a paper that will justify that hedge ratio," she says.

Thus, "you can choose to be unhedged because you believe that it's random noise that evens out over time, or because you believe the Canadian dollar tends to be pro-cyclical and that maintaining international currency exposure can lower the volatility of your portfolio. You can decide that currency exposure increases your portfolio risk, and be 100 per cent hedge. You can look at those two camps and say, 'I don't really know so I'll hedge 50 per cent,' and I'm going to be right at least half of the time."

But, she adds, "you're also going to be wrong half the time."

CARRYING ON

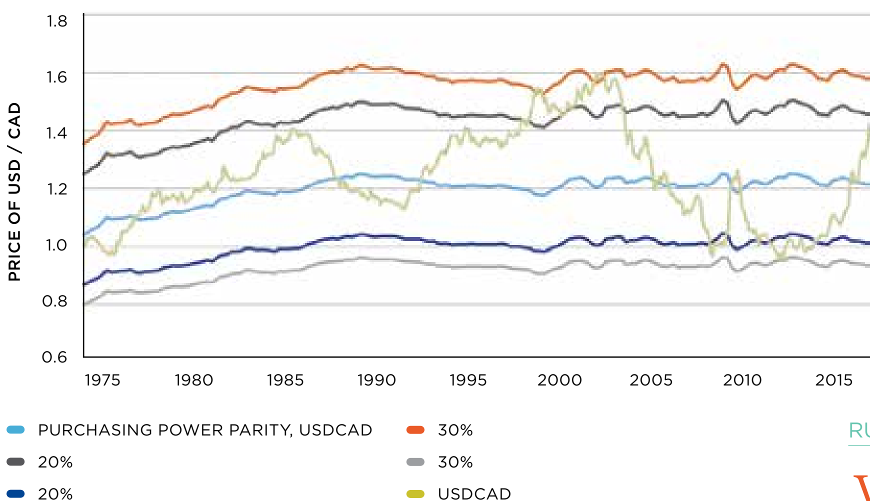
Instead, a systematic approach would involve dynamic hedging focusing on three premia – carry, value and trend – or momentum. That would mean shorting currencies with low interest rates and going long on currencies with high rates; shorting overvalued currencies, based on purchasing power parity, and buying undervalued ones; and, finally, giving greater exposure to currencies that are trending up over three-, six-, nine- and 12-month periods.

In such a strategy, more weight could be placed on momentum, since trends are long-lived in the currency space. In a model exposition, Dion points to the trend of the Canadian dollar in the period from 1999 to 2016, where it was first undervalued, reached fair value against the U.S. dollar in the mid-2000s, and then moved into overvaluation territory before reversing in 2011.

Value goes hand-in-hand with trend, Dion says, but it can take a long time for currencies to revert to fair value – although they eventually do. Carry requires more care because, she says, "carry works really well until it doesn't."

Over the period she examined, the dynamic hedging strategy delivered better returns than did no hedging, or a static hedge, without increasing risk, Dion says. But to implement a hedge strategy, Dion urges sponsors to pay attention to fees, which can vary considerably from investment dealer to investment dealer.

OPTIMAL HEDGE RATIO VARIES OVER TIME



Source: Thomson Reuters Datastream, Q3 2016. USD/CAD exchange rate from January 1975 to July 2016. PPP USDCAD +/- 20% and +/- 30% deviations. The Purchasing Power Parity (PPP) ultimately means equalizing the purchasing power of two differing currencies by accounting for differences in inflation rates and cost living

RUSSELL INVESTMENTS

Valerie Dion

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BY CAROLINE CAKEBREAD

THE ELEPHANT IN THE ROOM: ASSET MANAGERS AND OWNERS NEED TO HAVE A NEW KIND OF CONVERSATION

There is no substitute for time, particularly in asset management, where time horizons can have a powerful impact on investment outcomes. The dialogue between investment managers and asset owners has to change; there is an elephant in the room that everyone is stepping around. It's been created by a fundamental misalignment of expectations that runs from the top to the bottom of the decision-making chain – and it needs to be addressed, according to Nadia Savva, director of institution sales, Canada, and Colin Sinclare, managing director, institutional sales, Western Canada, MFS Investment Management.

As Savva notes, the investor-manager conversation was much more straightforward back in 1995, when a portfolio of fixed income and cash could easily generate a target return of 7.5 per cent.

Not so today, however – as she points out, "To get that same target return, you need to choose from a plethora of asset classes and strategies that increase in risk and complexity."

An additional challenge lies in the "friction" that exists between the principal agents in the decision-making process – in particular, a mismatch between time horizons. Consider that, at the top level, pension policy looks far out – north of 40 years in some cases – while asset management is focused on the full market cycle, between seven and 10 years. At the governance level, the board and investment committee are focused on a one- to five-year time frame.

At this level, the conversation too often doesn't include an assessment of the long-term performance sustainability of an investment manager. Hiring and firing decisions over these shorter time periods have shown to be counter-productive.

It doesn't add up to a cohesive decision – but how can asset owners and asset managers move beyond these pro-cyclical friction points?

MFS INVESTMENT MANAGEMENT

Nadia Savva

DIRECTOR OF INSTITUTIONAL SALES, CANADA

MFS INVESTMENT MANAGEMENT

Colin Sinclare

MANAGING DIRECTOR, INSTITUTIONAL SALES, WESTERN CANADA

COLLECTIVE INTELLIGENCE

Sinclare argues that qualitative criteria should be added to the quantitative side of investment manager hiring – questions that look more closely at how effectively investment managers make decisions and execute them.

"It's next to impossible to have an information advantage in this industry," Sinclare says, "but managers look to create an analysis advantage through investment teams."

This is where asset owners should be asking questions and aiming to assess the culture, team and the ways in which an organization fosters collaboration and idea-sharing.

"It's hard to do in practice," admits Sinclare, but it's not impossible.

The MIT Centre for Collective Intelligence points to success factors that can dictate whether a company can outperform. It's not about beating a benchmark or building a tool – it's about fostering the environment needed to truly collaborate and share knowledge.

"A team that thinks about the same problem differently adds value," says Sinclare. "Effective sharing of knowledge within a team can lead to improved decision-making outcomes."

So, one way to get around the elephant in the room is to start a conversation about collaboration and alignment of time horizons – and to get beyond the benchmark.

BY SCOT BLYTHE

THE BOARD EDUCATION BUFFET: WHY IT'S IMPORTANT NOT TO OVERFEED TRUSTEES TOO MUCH INFORMATION

In advance of the conference, we interviewed Lloyd Komori, risk and governance expert, and faculty member of The Directors College, about the challenges of assessing risk from the perspective of both a board member and a risk manager.

"Many management teams struggle to discern what the board wants," notes Komori, who has been (at different times) on both sides: the leader of a risk management function and a member of a pension plan's board of directors. "They get caught in this kind of guessing game: 'Do I share this, do I not share that?' They keep trying to guess what the other side wants or has."

One consequence may be too much information – or a never-ending quest for it – information that may not be essential or even appropriate. Management often provides the board with way too much material in an effort to be "fully transparent." However, when directors/trustees are given tons and tons of material, they often don't know what to make of it.

The key to information management, in part, is education, Komori explains. "I don't believe a board director needs to go to actuarial school. I think it's incumbent on the management team, be they risk people, be they investment people, be they actuarial people, to convey the key messages in simple, straightforward language."

And it's equally important, he adds, for management to show courage – and to draw lines against what might be construed as getting into the "management kitchen" by board directors/trustees. This can occur if board members have prior experience in the investment industry and feel that they can make a contribution.

"I do think it is important for a board to have a diversity of technical skills and experience," he says. "But, at the end of the day, there's a line that separates direction from suggestion and that line should not be crossed." Sometimes a board member can push too far into investment practices by recommending specific actions based on their prior experience in management. Management often feels they need to heed these recommendations because of who is offering them, Komori explains. This will create accountability issues in the future, when something that a board director recommended and management initiates goes south.

To that end, management needs a plan on what and how it's communicating to the board, especially as it relates to the board's responsibility for the oversight of risk management.

Komori's philosophy is for management to provide their board with concise and strategic insight into how risk is measured and managed. The board should have a view of what they need to see in order for them to fulfill their fiduciary obligations.

Determining how much information is presented is another challenge. Education is a continuous process and needs to be systematic, transparent and practical.

The pace of how education is rolled out must also reflect the board's capacity to consume and digest.

"The menu proves an apt metaphor," says Komori. "You don't want to shove the whole meal in front of the board," he explains. "We've got a menu: you've got your appetizer, your main course and your dessert. We're not going to give you the entire meal all at once. Maybe you do it over a year or a bit longer, depending on the receptivity and the capacity of the board. The menu is the limit; that's the point. You can't keep on going back to the buffet. It's a fixed-price menu."

OMERS

Lloyd Komori

SENIOR VICE-PRESIDENT, RISK MANAGEMENT

BY CAROLINE CAKEBREAD

THE BEST OF BOTH WORLDS: THE ROLE OF STYLE FACTORS IN FUNDAMENTAL ACTIVE MANAGEMENT

Undeniably, traditional active management has been losing market share over recent years. Bottom-up stock pickers are faced with increasing competition from new beta-based approaches. Enhanced Indexing or smart beta terminology aside, the basis of this shift is entrenched in the argument that factor-based models are return additive at a significantly lower cost than the traditional active manager. Andrew Flynn, CFA, partner, and co-portfolio manager for the William Blair International Small Cap growth and Global Leaders strategies, explains.

"Historically, fundamental managers have focused too much on outperformance rather than risk," he says. The result is an overall industry that has delivered mediocre performance, especially when considering the volatility of returns and – as investors will inevitably remind you – fees. Flynn explains that a combined approach of conventional active, fundamental stock selection and the incorporation and understanding of factor exposures is superior to either a purely fundamental or purely factor-based approach.

"High quality stocks have always held a premium over low quality ones – but, post-2008, investors are now paying very high prices for value," he explains. "Slowing global growth has led people to migrate to companies that can execute strategies and grow earnings nicely. Investors today favour reliable corporate performance at the expense of everything else."

As expensive stocks take on a more influential role in indices based on momentum, value and volatility factors, the market will revert, pushing pure passive investors into the red.

WILLIAM BLAIR

Andrew Flynn

PORTFOLIO MANAGER, INTERNATIONAL SMALL CAP GROWTH AND GLOBAL LEADERS STRATEGIES

Flynn cautions that, as expensive stocks take on a more influential role in indices based on momentum, value and volatility factors, the market will revert, pushing pure passive investors into the red.

An integrated approach allows for an objective, unbiased discipline of a systematic approach, and experienced-based oversight of a pure fundamental manager. Flynn adds that a contemporary approach to combining traditional fundamental and systematic methodologies can result in superior risk-adjusted returns through market cycles, and downside protection in times of disruption.

BY SCOT BLYTHE

INVESTMENT RISK REDUCTION STRATEGIES: HOW NEW BRUNSWICK TACKLES ASSET ALLOCATION

A number of New Brunswick's public sector pension plans have, since 2014, shifted to target a benefit or shared-risk approach. That approach can include increasing employer and employee contributions, tethering benefits to career average earnings and raising the retirement age.

From an investment strategy perspective, it has also meant constant measurement and monitoring of funding ratios. Annual tests of funding ratios – for base benefits and inflation indexing – set the framework for asset allocation, says John Sinclair, CEO of the New Brunswick Investment Management Corporation (NBIMC), which has $13 billion in assets under management, 87 per cent of which are managed in-house. NBIMC provides investment strategy and investment services for a number of New Brunswick–based public sector pension plans.

> *We introduced minimum-volatility portfolios in 2011 and have gained some pretty good risk and return experience to date.*

Sinclair shared his experiences during his presentation, and led a case study on risk management for shared-risk pension plans. He sat down with us before the event and answered our questions.

"It has certainly changed the allocation to equities, particularly market-cap based equities," Sinclair says. But NBIMC had already been evolving to managing non-market cap public equity approaches.

"One of the things that we had done, even before these changes in the pension plans took place, involved designing minimum-volatility portfolios. We introduced minimum-volatility portfolios in 2011 and have gained some pretty good risk and return experience to date."

Compared to other public-sector pension plans, which typically aim for a four per cent real return, New Brunswick's shared-risk plans target approximately 2.5 per cent, and that also has an impact on the asset allocation.

"In terms of the traditional target benefit or the initial anticipated asset mix, it would be much more heavily weighted to fixed income versus equities and much more targeted to long-dated fixed income: almost an immunization-type approach," Sinclair adds. However, the shift to fixed income, which also meant adding to corporate bonds, was not as drastic as might have been predicted, he says.

"Considering where markets were, and our experience with minimum volatility, we were able to look to more weighting in equity than was originally anticipated, but primarily in a heavier weighting in low-volatility equity. That would provide the same approximate risk characteristics of the initially anticipated portfolio."

NBIMC does manage alternative assets, and it's building out its portfolio. In contrast to bigger pension plans with better access to deal flow, Sinclair says, "we probably have a higher allocation to public securities. But, in trying to design those public securities portfolios, we use things like low-volatility and a number of absolute return strategies to better match the mission or the liabilities of the plans, rather than just take market-cap benchmark exposure."

NEW BRUNSWICK INVESTMENT MANAGEMENT CORP

John Sinclair

PRESIDENT AND CEO

BY SCOT BLYTHE

ALL ABOUT ANNUITIZATION:
PANEL DISCUSSION HIGHLIGHTS THE BENEFITS AND CHALLENGES OF ANNUITIES

GEORGE WESTON LTD. AND LOBLAW COMPANIES LTD.
John Poos
GROUP HEAD, PENSIONS AND BENEFITS

OSLER
Julien Ranger
PARTNER, PENSIONS AND BENEFITS

MERCER
Andrew Whale
SENIOR ASSOCIATE AND ANNUITY STRATEGIST

SUN LIFE FINANCIAL
Heather Wolfe
MANAGING DIRECTOR, CLIENT RELATIONSHIPS, DEFINED BENEFIT SOLUTIONS

Where there's a growing demand, there's also a growing supply as Canadian plan sponsors seek to better manage their balance sheets by laying off funding risk through annuities. This was a key takeaway during a panel discussion focused on how and why Canadian pension funds are turning to annuities.

For John Poos, group head of pensions and benefits at George Weston Ltd. and Loblaw Companies Ltd. – Canada's largest business by both revenue and head count – it meant first moving 17 different pension plans into a fully funded position. But before tranching them out, he had to convince a board wary of legal risks, and divide the workings of a marketplace where decisions have to be made in the space of a day – a good six months of preparation.

"You can do a back-of-the-envelope assessment of what your liability looks like relative to your funded status," he says, "but you don't know how the market is going to react, you don't know how anxious the carriers are, you don't know what kind of pricing you're going to get. You're somewhat guessing when is the right time."

Data – lots of it – helps, says Heather Wolfe, managing director of client relationships, defined benefits solutions, at Sun Life Financial. "The more high quality data the insurance company has, the better the price is likely to be."

But preparation goes beyond that. In the U.K., where the annuitization market is more developed, carriers have declined to bid on some annuity purchases, saying "do you have your decision makers on board, do you have your governance, do you have a realistic pricing expectation, what shape is your data in?" she notes.

An annuitization "does create legal risk that you need to address, and the way you do it is by first having a good governance framework in place," urges Julien Ranger, a partner specializing in pensions and benefits at Osler.

"Your governance framework should allow the decision-maker to understand in which capacity it is acting when making that decision. There are many decisions involved throughout the de-risking process – some of them are going to be made as a plan sponsor and some others are going to be made as a plan fiduciary." That covers the boomerang risk if an insurer goes bankrupt after a plan has been annuitized – which Ontario is addressing – but also such matters as contracts and privacy.

However, the window shuts very quickly, adds Andrew Whale, senior associate and annuity strategist at Mercer: "If you were to just decide today to buy an annuity and go out to the market to see what would happen, it's luck that you may hit the right day and the right combination of unused demand." Dialogue with potential carriers and consultants will lead to a more transparent, predictable and defensible outcome.

2016 RISK MANAGEMENT CONFERENCE

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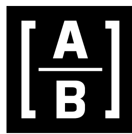

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